



HOUSE OF LORDS

Unrevised transcript of evidence taken before

The Select Committee on Economic Affairs

Inquiry on

THE ECONOMIC IMPLICATIONS FOR THE UNITED KINGDOM OF SCOTTISH INDEPENDENCE

Evidence Session No. 9.

Heard in Public.

Questions 430 - 481

TUESDAY 17 JULY 2012

3.35 pm

Witnesses: Professor Iain McLean and Paul Ingram

USE OF THE TRANSCRIPT

1. This is an uncorrected transcript of evidence taken in public and webcast on www.parliamentlive.tv.
2. Any public use of, or reference to, the contents should make clear that neither Members nor witnesses have had the opportunity to correct the record. If in doubt as to the propriety of using the transcript, please contact the Clerk of the Committee.
3. Members and witnesses are asked to send corrections to the Clerk of the Committee within 7 days of receipt.

Members present

Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Hollick
Lord Lawson of Blaby
Lord Lipsey
Lord McFall of Alcluith
Lord Rowe-Beddoe
Lord Shipley
Lord Smith of Clifton
Lord Tugendhat

Examination of Witnesses

Professor Iain McLean, Professor of Politics, Oxford University and Fellow of Nuffield College; and **Paul Ingram**, Executive Director of British American Security Information Council.

Q430 The Chairman: Good afternoon, and welcome to the Economic Affairs Committee. This is our ninth public hearing of our inquiry into the economic implications for the United Kingdom of Scottish independence. I just have to repeat that hard copies of Members' entries in the Register of Interests are available in the room.

Dr McLean and Mr Ingram, thank you very much for coming, and thank you Dr McLean in particular for the written evidence you have given us, on which we will have a number of questions and which we found very interesting. I should be grateful if you would speak loud and clear for the webcast and the shorthand writer. Would you like to make an opening statement or can we go straight to questions?

Professor Iain McLean: For the sake of the webcast, I apologise for signalling problems outside Reading; otherwise I am happy to let my evidence—

Q431 The Chairman: We apologise that we had domestic matters to consider, so it did not really cause a problem. Perhaps I may begin with a very general question. Both in your

written evidence and in evidence from a lot of other witnesses, there has been a lot of stress on the need for negotiation over many of the important issues. We readily recognise that. In your view, how long might these negotiations take? It is fairly clear from your paper but could you just also spell out which you think are the key issues? Do you think that that long period of negotiation might act as a disincentive or have a negative impact on businesses and on the perception of the economies and so on in the meanwhile?

Professor Iain McLean: Thank you, Chairman. The two analogies that I have studied are the case of Ireland in 1921 and the Czech and Slovak Republics in 1992 to 1993. In both those cases, once a split had been decided on, the negotiations were, one might say, remarkably quick. In the Irish case, discussions began in October 1921 and they were concluded on 6 December of that year. In the Czech and Slovak case, negotiations began after the last federal election in June 1992 and were concluded in time for a split-up on 1 January 1993. This was then followed by a monetary union, which lasted in effect only a matter of days. Other cases which could be possible analogies, such as the break-up of Yugoslavia, I am not qualified to comment on.

Would a Scottish/rest of UK negotiation be comparable with those? In one sense, it might be less rapid because in both those cases it was negotiation under duress. In the UK/Irish case, the Government of Lloyd George were threatening to revoke the truce that was in place, and the Irish, among themselves, thought that they might lose any ensuing war. In the Czech/Slovak case, the urgency was driven by the currency issue, which was recognised by all the bargainers as needing an urgent solution. In the Scotland/UK case, we might say that there would be no hurry because there are none of these wars or potential wars that would have affected the Irish or Yugoslav cases.

On the other hand, I think that the currency and financial regulation issue would add urgency to the bargaining. There could be risks, such as a speculative run on the expected

depreciation of the Scottish pound, which could give it the same degree of urgency as in the Czech/Slovak case. Of course, to answer your final question, this could lead to quite a lot of—to put it mildly—anxiety on the part of agents, especially financial businesses in Scotland, although I think somewhat less so in the rest of the UK. That then leads to the conclusion that the rest of the UK would be in less of a hurry than the Scottish negotiators, which gives rather a close analogy with Ireland in 1921.

Q432 Lord Lawson of Blaby: For the avoidance of doubt, can you confirm that what you are talking about is negotiations after the referendum in the event of the referendum going in favour of independence, rather than the possibility of negotiations before?

Professor Iain McLean: Correct. I am sorry; I should have made that clear.

Q433 The Chairman: There are also a lot of witnesses who are saying that you cannot have a sensible referendum unless there is a proper analysis of some of the key issues—and I think we all know what the key issues now are. Would you agree with that?

Professor Iain McLean: Absolutely. With colleagues, I am trying to supply some of that non-partisan evidence. Members will be aware that the British Academy and the Royal Society of Edinburgh have a joint initiative on these matters. I have just learnt that the Economic and Social Research Council has issued a call for proposals, which I intend to respond to. So I think that serious academic analysis of a non-partisan sort is starting to happen. You may feel that it is now rather short notice before the referendum date but it is starting to happen.

Q434 The Chairman: One of the problems being identified is that many of the issues will be subject to negotiation and, because of that, the analysis cannot be clear-cut.

Professor Iain McLean: I agree.

Q435 Lord Tugendhat: You raise some very interesting defence-related points in your paper. Perhaps I may ask a very basic question. Can you give us an idea of the overall

number of servicemen posted at defence bases in Scotland and, more to the point, the number of civilian jobs supported by those bases?

Paul Ingram: The latest figures available suggest that there are somewhere in the region of 12,000 service personnel in Scotland, although that does not take into account changes since 2010, which of course are reasonably substantial as a result of the SDSR and the plans after that. The number for civilian personnel is just under 6,000, and the estimate for the defence industry is 12,500. The numbers are always a little uncertain around the defence industry because it is very difficult to categorise when we are talking about sub-contractors and when we are talking about secondary suppliers, who are, by their very nature, dual-use. The impact of any decision is clearly uncertain. I may be running ahead of you there but those are the current numbers.

Q436 Lord Tugendhat: Would you agree with me that, to some degree, your reply understates the economic impact of the bases? I have in mind two things. I cannot remember what the big base was in Essex but when the Americans ran it down, although Essex is a very prosperous part of the country, being close to London and so forth, that caused a lot of disruption to the local economy. Perhaps a more interesting example is that when the Americans started to run down their very substantial establishment in Germany, a number of German communities actually pleaded with the Americans to stay because they had been there a long time and the local economies, to some extent, regarded the American bases as part of the fabric of their local society. I should have thought that to some extent the same might apply in Scotland.

Paul Ingram: The numbers that I just quoted to you were for direct service personnel—civilians employed directly on the bases—and for defence industry suppliers specifically. I was not talking about multiplier effects within the community in the way that you would describe—

Lord Tugendhat: You mean shops and all the rest of it.

Paul Ingram: Exactly. Every transition is costly when it comes to economic transitions such as these. That does not mean to say that those shops may not find other sources of income in the future, but there are inevitably transitional costs, which are larger than the main numbers that I was describing just now.

Q437 Lord Lipsey: To put the numbers in context, how does this compare with the percentages in areas in the rest of the UK which are involved in similar ways? Is it particularly defence-intensive or defence-light in Scotland or what?

Paul Ingram: It is more defence-intensive in Scotland in terms of the number of service personnel who are from Scotland compared with the rest of the UK—not significantly more but a little more. Many of those service personnel from Scotland are not based in Scotland, so the economic multiplier effects that we were describing are not all simply because they are Scottish service personnel. If we simply look at the number of bases and the number of Scottish personnel who are deployed in Scotland, it is roughly equal to the rest of the United Kingdom.

Q438 The Chairman: I do not know whether you saw Francis Tusa's evidence to the Scottish Affairs Select Committee of the House of Commons in May. One of the arguments has been that Trident could not be moved from Scotland very easily and that the cost of such a move would be very high. I think that at one point he described it as "one of the biggest red herrings". He was arguing that they could very easily be deployed elsewhere in the United Kingdom. Have you any view on that?

Paul Ingram: It is certainly not what the Minister for the Armed Services said a few weeks back in evidence. It is the opinion of many analysts within my community that there are significant problems with relocation, and not just the actual porting of the submarines, which is manageable—obviously submarines already go into Devonport for refits and the like. The

principal challenge is the location of the armouries for the nuclear warheads, along with the inevitable public inquiries, the political impact and the geological basis, which implies health and safety. At the moment, at Coulport there are of the order of 2,000 to 3,000 residents who would be at risk if there were an accidental nuclear explosion. If we were to base nuclear weapons in Devonport, you could look at a factor much larger than that, with local impacts when it came to the political fear of having these stationed, and that would create all sorts of challenges. There is certainly a financial cost when it comes to upgrading the bases elsewhere to take these weapons. Nick Harvey, the junior Minister, has given an estimate of the order of tens of billions of pounds. He has not gone into that. He did not have any Civil Service back-up for that number but he based that estimate on the fact that they have already spent, in recent times, £3.5 billion to upgrade the Faslane facilities to take the Vanguard and Astute class submarines. So one could assume that building facilities from scratch would cost a great deal more than the £3.5 billion that has already been spent. Therefore, there are financial costs but there also are a number of other significant costs that would make it difficult.

Q439 Lord Forsyth of Drumlean: Just on the Francis Tusa point, I do not know whether you read the evidence that he gave to the Scottish Affairs Select Committee.

Paul Ingram: No, I did not.

Lord Forsyth of Drumlean: On the point about the storage of the warheads and the issues which you say have been raised by the Defence Minister among others, he said, “It is very easy. Aldermaston and Burghfield have spare storage capability and have full nuclear licences. Coulport is sized for a deterrent with five”, and then he was interrupted. He was implying that there were no difficulties at all.

Paul Ingram: If one were to store the warheads at Aldermaston and Burghfield, which would indeed be a rational thing to do, you would still need to have the loading facilities.

You obviously cannot load a submarine at Aldermaston or Burghfield, and you would need some temporary storage facilities because you could not do this sort of activity on an off-the-shelf, immediate basis. It would not satisfy health and safety procedures.

Q440 Lord Forsyth of Drumlean: For someone who operates on soundbites, in your view what would the cost of moving the nuclear deterrent out of Scotland be, and how many jobs would be lost as a result?

Paul Ingram: My view is that we are looking at a cost of the order of at least £7 billion or £8 billion. I have been looking at the costs of a number of different options recently and that is the sort of level that we would be looking at.

Q441 Lord Forsyth of Drumlean: And the number of jobs, direct and indirect?

Paul Ingram: Jobs lost in Scotland are of course jobs going elsewhere.

Lord Forsyth of Drumlean: I have a bias towards the numbers in Scotland.

Paul Ingram: For jobs lost in Scotland, we are probably looking at the order of 2,000¹.

Q442 Lord Lawson of Blaby: If it is considered important that the United Kingdom retains an independent nuclear deterrent, it is difficult to see how that could possibly make sense if you were based outside the United Kingdom. So that cost would have to be met. Are you suggesting that somehow the United Kingdom might have a sovereign base in Scotland analogous to what we used to have in Cyprus?

Paul Ingram: What I am suggesting is that there are a number of different options to be negotiated. This side of a referendum, for all the reasons that we talked about earlier, it is difficult to judge how that would come out, but it would certainly be in the strong interests of London to maintain the base up in Faslane. Because of the costs and because of the

¹ "This is probably an underestimate. There are of the order of 3000 service personnel and 4000 civilian personnel including contractors (mainly Babcock) currently based at Faslane and Couplort combined. This is the main navy port in Scotland, and it is likely that there would remain some navy presence after the removal of facilities associated with the nuclear deterrent, so job losses would be of the order of 7000 minus any jobs created by the new navy."

complexities, we would be looking to try to maintain those facilities in Faslane for as long as possible.

Lord Forsyth of Drumlean: But the nationalists have a clear policy, which is to remove nuclear weapons from Scottish soil. That is a long-standing policy, so Lord Lawson's question is—

Paul Ingram: It is very pertinent and also extremely difficult for me to answer, because it is more of a political question of how much the Members of the new Scottish Government will be prepared to face down either their domestic public or the pressures coming from London. At this point in time, I do not think it is very easy to give you a clear, definitive judgment as to how that would pan out.

Q443 Lord Forsyth of Drumlean: One other quick soundbite question. Assuming that the nationalists were as good as their word and wanted the independent deterrent out of Scotland, how long would our independent nuclear deterrent not be working while this process was achieved? Or would it be possible to continue to operate it in those circumstances?

Paul Ingram: If the Scots were to force the closure of Faslane and Coulport within the space of a few months, it would obviously take several years to build alternative facilities. My prediction is that, if the Scots were willing to take the political consequences of such a decision, which would be significant, then the rest of the United Kingdom, were it to decide that it would retain continuous at-sea deterrence, would do so out of King's Bay, Georgia or indeed it may even come to an agreement with the French to use the Brest facilities.² There are no facilities that it could use with any confidence in England in the mean time.

Professor Iain McLean: May I come in with a supplementary to both those questions? I have discussed the sovereign base issue in written evidence, which Members will have seen. I

² It should be noted that both these options come with considerable logistical as well as political challenges that should not be underestimated... not least on the transport of British nuclear warheads for storage and loading.

draw attention to the fact that the United Kingdom and Ireland, which had been in a guerrilla war for two years, were able to come with remarkably little controversy to an agreement that the UK should retain three sovereign bases in what was then the Irish Free State. No less a person than Michael Collins was perfectly happy to agree to this. So the way that I would see the scenario which Lord Forsyth and Lord Lawson are developing is that, if the Scottish Government's first move was to say, "They have to be out in six months", the rest of the UK negotiators would say, "Okay, in that case you can forget about any of the negotiations about the other things which you need"—such as financial regulation, which no doubt we will come to later. So my prediction, for what it is worth, is that, although that might be the first move, it would not be the final one and in that event I would envisage a sovereign base agreement being able to be reached.

Of course, this is affected, as we speak, by what appears to be a change in SNP policy. The clerk has just sent us a note of a story from BBC Scotland today which has been in the air and presumably Members have also seen it. The SNP defence spokesman is actively trying to alter his party's stance on NATO, and of course none of us knows what the outcome of that will be.

Lord Forsyth of Drumlean: On NATO but not on the nuclear deterrent.

Professor Iain McLean: On NATO but not on the nuclear deterrent. That is correct. I presume that it is unnecessary for me to read this out. I dare say that it has occurred to Members of the Committee to ask Mr Robertson to appear before them to answer that question.

Q444 Lord McFall of Alcluith: Would that be equivalent to banks setting up branches in different areas which, in the case of Scotland, would be a bank without any money? Is that a comparable analogy? They want to get rid of the nuclear weapons but they want to be members of NATO. Paul, the point I would like to make to you is that Faslane and Coulport

are in an area of Scotland where comparatively unemployment has been historically high. Would the 2,000 job losses you are talking about be concentrated locally?

Paul Ingram: Yes.

Q445 The Chairman: And the 2,000 job losses would be direct job losses? You are not calculating the other effects?

Paul Ingram: There would probably be another 2,000 or 3,000 jobs that would be affected in one way or another.

Lord McFall of Alcluith: Locally?

Paul Ingram: Yes. With regard to NATO, I would like to draw your Lordships' attention to the example of Norway. It is a very loyal member of NATO. It sits on the Nuclear Planning Group and indeed supports, as all NATO members do, the policy of NATO remaining a nuclear alliance for the foreseeable future for as long as other countries have nuclear weapons. Norway also has a policy of banning any nuclear weapons on its territory in peace time, and that is a policy that it has maintained for quite some years. It is also probably the largest funder of non-governmental organisations working to reduce the salience of nuclear weapons in global politics. So it seems to be able to have that dual policy—or two-faced policy, you could say, although I would not like to be quoted on that; perhaps I should say “looking both ways”. NATO is often a very flexible organisation that has been able to deploy in all sorts of different environments in a flexible way, and its members are equally flexible when it comes to their interpretation of what their responsibilities are.

Q446 Lord Forsyth of Drumlean: Just on that, you drew our attention to the BBC press release and the statement that is being made, which suggests that an independent Scotland, as a member of NATO, would take part in an operation only if it were sanctioned by the United Nations. I thought that the whole idea of NATO was that if one was attacked,

all came to the defence, and that you could not go to the United Nations to say, “Is it all right?” Is that wrong?

Paul Ingram: Under international law, UN Charter Article 51 gives every state the right to self-defence. The alliance makes that a multinational responsibility and ability. My interpretation—and it may be wrong—of what he is saying there is that the Scots would not go out of area to fight wars outside of NATO without United Nations endorsement. However, I am not a member of the SNP and that would just be my interpretation.

Lord Forsyth of Drumlean: I was just asking whether that is within the NATO rules.

Paul Ingram: It is within the NATO rules to be a NATO state and not engage in a NATO operation out of area that is not an Article 5 operation under the North Atlantic Treaty.

Lord Forsyth of Drumlean: But if it was an Article 5 operation?

Paul Ingram: Article 5 is part of the NATO treaty—the North Atlantic Treaty—that talks about each member making a commitment to collective self-defence. It is self-defence that is important; it is not defence of interests outside of area.

Q447 Lord Smith of Clifton: We have more or less covered the question that I was going to ask. My colleagues have encroached on it, not for the first time in my experience. Turning from defence, if an independent Scotland were to use sterling as its currency, do you envisage any arrangements whereby the Bank of England could have responsibility for providing services, such as lender of last resort, to Scottish-based institutions? Would it be preferable for an independent Scotland to have its own monetary authority or central bank? Are there lessons from history of what a preferred arrangement might look like between two separating countries?

Professor Iain McLean: That is a large question, and I hope your Lordships will forgive me for giving a rather complex answer to it. Current Scottish Ministers, including the Finance Minister, John Swinney, have suggested that the contingencies raised by Lord Smith are

irrelevant on the grounds that an independent Scotland would simply adopt the pound sterling as its currency without consulting the rest of the UK. There have been analogies to this. Ecuador and Argentina have adopted the US dollar, and Montenegro has adopted the euro. However, I think that that is a soundbite for domestic consumption—although you would have to probe this with Mr Swinney and not with us—because I do not think that it is a realistic bargaining stance. Were that to be suggested after a yes vote on independence, the effect on the morale of Scottish financial institutions would be considerable. Scottish financial institutions are going to need certainty as quickly as possible on the range of questions which Lord Smith has just raised.

In realistic bargaining between the Scottish delegation and the rest of the UK delegation, it seems to me that the Scots must either ask for Bank of England responsibility for the services you mention in your question or they must offer a set of arrangements that the rest of the UK, and most significantly the Bank of England itself, regard as acceptable. In my view, and I am far from the only one who takes this view, the two issues that are likely to be the most crucial in post-referendum negotiations are the one that we have just discussed—nuclear weapons—and the one which Lord Smith has just raised.

You asked me to talk about international comparisons, and I am very grateful to the clerks, who gave me some notice of this question so that I could do a little bit of research. In the Czech/Slovak case of 1993, it is important to say at the outset that the monetary authorities of the two countries worked entirely harmoniously. They both realised that splitting the currency needed to be done with extreme urgency, with quite a degree of secrecy and with arrangements such that there was not a run on the banks in either country or, in particular, a run on the banks in Slovakia. So it can be done by agreement. I think that the position enunciated by the Scottish Finance Minister is unrealistic—that Scotland might simply unilaterally do something and not even bother to seek negotiations with the rest of the UK

or walk out of negotiations with the rest of the UK. I think that the effect on the Scottish financial sector of even threatening that, let alone doing it, would be calamitous.

Q448 Lord Smith of Clifton: Do you think that there will be a pre-emptive strike by Scottish banks whereby they might, in anticipation, hive off their English activities and register them in London, as indeed the Irish banks have now done following the eurozone crisis? I am talking about banks here which were protected by the Bank of England and by regulatory rules here.

Professor Iain McLean: The issues relating to retail banks and investment banks are different. Let us take the case of the retail banks. I think that they would be very remiss if they were not making those plans already. On the other hand, if you were to call the Scottish retail banks to give evidence, you would not get anything out of them, for obvious reasons. Therefore, I cannot confirm for sure that they are making those arrangements already. However, of the Scottish-domiciled retail banks, RBS and HBOS have the majority of their UK customers in the rest of the UK. I do not know about Clydesdale Bank but certainly a lot of its customers will be in the rest of the UK. So those customers would come under UK regulations in any case, whether or not the banks took any active steps to regulate them.

As regards investment banking, I have almost no expertise in the subject but I would have thought that the Scottish and London investment banking markets or arenas are so integrated that any operations that go on in Scotland could be quickly transferred to London, but that is going outside my area of expertise.

Q449 Lord Smith of Clifton: Professor McLean, if it looked as though the strength of support for independence in Scotland was growing, do you think there would be a flight of capital generally and commercial activity away from Scotland to England or elsewhere in the

UK, as happened in the case of Canada, when it looked like Quebec might go separate and business fled from Montreal to Toronto?

Professor Iain McLean: That is a possible analogy. On the other hand, for what it is worth, that did not happen in the Czech/Slovak case, even after it became clear that there was going to be a split. It should be borne in mind that that did not become clear until after the election and after the leaders of the Czech and Slovak federal units set out their stalls. In that case, there were immediate serious monetary issues but not serious capital flight issues. One might say that in Canada in 1995 capital was more mobile because it was a mature capitalist economy, whereas the Czech Republic and Slovakia were emergent economies at the time, so it may be that the Canadian scenario is more realistic than the Czech/Slovak one. Should the money which the ESRC is about to make available become available to people like us, that is a question that I would like to research further.

Q450 Lord Lawson of Blaby: The point that you made about Canada being much more highly developed financially than central Europe at that time is very important. The other point is the size disparity. Although the Czech Republic and Slovakia are not of equal size, the disparity is nothing like as great as that between Scotland and the rest of the United Kingdom. I think that this is a further reason for suggesting that the Czech and Slovak precedent is not all that compelling.

Professor Iain McLean: I believe that it is compelling in some respects and not in others. To put it on the record, the population ratio of Czechs to Slovaks is about 2:1 compared with about 9:1 for the rest of the UK to Scotland. Let me also take the opportunity to say that the UK's greatest expert on this, if you want to probe this further, is Karen Henderson of the University of Leicester, and I can give the clerks her particulars. She knows far more about this than I do.

Q451 Lord Shipley: I want to pursue the issue of regulation. Your written evidence suggests that the rest of the UK would have an interest in financial regulation or perhaps “clearing” regulation in Scotland. I would be interested to know more about what you have in mind. If the rest of the UK were to regulate Scottish institutions, would this not imply some liability if they failed? Is it possible for governance by a single regulatory authority to be accountable to two separate Governments?

Professor Iain McLean: These are also very weighty questions, so, once again, I thank the clerks for giving me notice that they might be raised. I have done some research, including speaking to a former member of the Monetary Policy Committee about these issues. A way to look at this would be to consider the bargaining table from the point of view of the rest of the UK negotiators. Their interest, it seems to me, would be in the status of the currency and our financial regulation in the rest of the UK, and in any contagion, spill-over or consequences that would undoubtedly be in their minds from the recent examples of Greece, Iceland and Ireland, and possibly other examples which may have occurred by the time these negotiations take place. Therefore, I envisage that the rest of the UK negotiators are going to be bargaining very hard and are not going to let the Scottish negotiators get any of the things which the Scots will predictably want—we know that the current Scottish Government have signalled some of the things that they will be looking for—unless the rest of the UK negotiators are completely satisfied that there is, from their point of view, a watertight regulatory system.

Because of the “One Man, Two Guvnors” problem which you have just raised, I suspect that a single regulator is not feasible, and therefore the rest of the UK negotiators would have to be content that the proposed Scottish regulatory structure was tight enough to satisfy the concern of preventing contagion. I do not know whether that is helpful.

Q452 Lord Shipley: As I understand it, you are saying that there would need to be separate systems of regulation. But do you think there is any danger in an independent Scotland of firms or financial institutions simply getting too big for the regulatory system that underpins them? Should that happen, might that be a fall-out of the rest of the UK being the place of last resort for help?

Professor Iain McLean: The most obvious cases which are already in everybody's minds are the two very large Scottish-domiciled banks, RBS and what is now Lloyds TSB, or the former Bank of Scotland component of that. That problem already exists but they are covered by the UK regulator. Undoubtedly, to follow on from my previous answer, if you agreed that you had to have two regulators, then those banks would have to split their Scottish operations from the rest of the UK operations in any case, and those would be regulated by the two different regulators. I sense behind the question some worry that this might create a new moral hazard to the effect that such banks might let some of their operations in Scotland go more recklessly than they otherwise would because they would think that the rest of the UK regulator would mop up any trouble. I cannot predict how that would go but I can see it as a possible risk.

In relation to non-bank regulated financial firms such as asset managers and so on, I think that my answer has to be rather similar. The Scottish regulatory regime will have to be very similar to the rest of the UK regulatory regime or the rest of the UK will not sign off on the independence deal for the same reason—that the rest of the UK would have a very urgent interest in preventing, just to pick at a venture, Aberdeen Asset Management from doing things under Scottish regulation that it would not be allowed to do under rest of the UK regulation.

Q453 Lord Shipley: Is there a danger that some financial firms might migrate in either direction? Might that scenario have an implication for the movement of jobs?

Professor Iain McLean: Yes, but my answer would be the same as the one that Paul gave earlier. The implications would be neutral for the present UK. Firms might move from Scotland to the rest of the UK or vice versa. But from the point of view of the population of the present UK, that is a separate issue.

Q454 The Chairman: If the system of regulation in Scotland was not as tight as it was in England or if the lender of last resort situation was very different and very unclear, is there not a risk that the international financial community would look much less favourably on Scottish institutions?

Professor Iain McLean: And on Scottish debt. Yes, that is certainly true.

Q455 Lord Forsyth of Drumlean: I do not want to put words into your mouth but I was just imagining that I was the chief executive or chairman of the Royal Bank of Scotland—not a happy prospect—and was faced with this. Under your scenario, I am going to have to have a different regulatory regime for my business in Scotland. I already have very high compliance costs in dealing with the existing regulatory regime. I am also going to have to operate in an environment where the cost of capital is likely to be higher because of the size of the country's balance sheet, and I am conscious that the Governor of the Bank of England has been telling everyone that the banks are too large relative to the balance sheet of the United Kingdom as a whole. Would I not be telling my board that we had to get out of Scotland?

Professor Iain McLean: I shall resist the temptation of having you put words in my mouth, Lord Forsyth.

Lord Forsyth of Drumlean: But can you explain why I am wrong?

Professor Iain McLean: I think that what you said does follow logically from the sequence of questions posed by Lord Shipley and from my agreeing with him that it is probably not feasible, post independence, to have a single regulator for the two financial regimes because

that regulator would be reporting to two Governments who would have different policy objectives. Therefore, I think it follows that there has to be a Scottish regulator and that therefore, as you rightly said, there will be extra compliance costs for Scottish-domiciled institutions. Whether the Royal Bank of Scotland would decide that it would leave the country in which it was founded in 1727 in order to deal with the Scottish equivalent—the money that came in to compensate the Scots for the Act of Union—and abandon Dundas House in St Andrew Square is a cultural question as well as a financial one, to which I think the likely answer is no.

Q456 Lord Forsyth of Drumlean: But a cost gradient would be imposed on financial organisations such as the Bank of Scotland, which, after all, was founded before the Royal Bank of Scotland in 1695 and did a deal with Lloyds and HBOS which was apparently driven by commercial considerations. The point I am getting at is: is the consequence of this that the cost of doing business in Scotland if you are a bank will be higher?

Professor Iain McLean: All other things being equal, the answer has to be yes.

Q457 Lord Hollick: I am struggling to understand how the Scottish banks get past day one. Currently, the inter-bank market is frozen. One way that banks can finance themselves is through the central bank. The Bank of England effectively sits in the middle of the spider's web at the moment. In those circumstances, without a central bank or the remaining part of the UK monetary framework, those Scottish banks which need to fund themselves on the wholesale markets—which would be the case for the two you have mentioned, even if you had hived off their London and international sides—would run out of money on day one.

Professor Iain McLean: I think that that is over-pessimistic because there would have to be a Scottish central bank. The question therefore would not be so much the credibility of the Scottish operations of the Scottish retail banks or the credibility of the Scottish financial banks. At least none of the Scottish retail banks that we have been discussing is only

Scottish. RBS and HBOS we have discussed, and Clydesdale has international links. There may be an issue which I am not competent to answer—and I hope you will call for evidence from those who are—on, for instance, the position of smaller Scottish building societies and so on. I think that there is a serious issue there and I regret that it would just be stupid of me to attempt to answer a question that is outside my competence.

Q458 Lord Hollick: Being a central bank, you can print your own currency. When it is not your own currency, you do not have that option.

Professor Iain McLean: That speaks to the three options, none of them hugely attractive, that would face the Scottish Government on the currency question, which has been rehearsed in front of you before, which are sterling—in which case, on what terms?— the Scots pound or the euro.

Q459 Lord Lipsey: At the moment, the United Kingdom has about 100 double taxation agreements with other countries, and Scotland would lose the benefit of those once independent. How quickly and how satisfactorily do you think it could negotiate replacement agreements of its own?

Professor Iain McLean: My first reaction—but again I am outside my comfort zone here—is that that is not a huge issue. There would be two things that the Scottish Government would have to negotiate. One is the double taxation agreement with the rest of the UK and the other is what it does as a successor state with all the existing UK DTAs with the rest of the world. In both those cases, the tax structure, the tax base and the tax rates are going to start on day one as being identical. Although, for sure, you should ask a witness from HMRC or an expert on these matters this question as well as asking me, my first reaction is that that would be one of the more tractable issues that could be dealt with in the independence negotiations.

Q460 Lord Hollick: Taxation is one of the areas that we have discussed with a number of witnesses—in particular, the ability of an independent Scotland to set its own tax rate and possibly follow the example of Ireland, which has been so successful in having low corporation rates and attracting quite a lot of companies to headquarter in Dublin. Do you think that that same opportunity exists for an independent Scotland or do you think, going back to the previous point about the double taxation agreements, you need to agree them with 100 countries, many of them in the European Union? Would they say, “Why should we agree to this if in fact all you are going to do is reduce corporation tax and take some of our company’s headquarters to your country?”. Is it a realistic prospect that an independent Scotland will have a significant degree of flexibility over its tax rates?

Professor Iain McLean: My one-word answer is no, for at least two independent reasons. The first is that the expert briefing paper you have had from Professor Rowthorn, which uses the numbers published by the Scottish Government in the GERS series, which I hope all Members are familiar with, shows that the day-one fiscal position of an independent Scotland would not be strong and therefore there would be very little, if any, scope for cutting any tax unless you also cut the level of public services.

The second reason is, as you alluded to in your question, Lord Hollick, that the EU in particular would take a particularly dim view of any promise by the Scottish Government to reduce corporation tax, just as it has taken an extremely dim view over the decades of the Republic of Ireland having done the same thing, and it has tried to bring some pressure to bear. The Republic of Ireland has its corporation tax level and it would be more difficult for the EU to force the Republic of Ireland to raise its corporation tax than it would be for the EU to make a condition of Scottish accession on terms which Scotland would be happy with that it does not reduce its corporation tax. Although I notice that there is huge political noise on this question both in Scotland and in Northern Ireland, it seems to me that the

politicians of all parties who are saying that Scotland could reduce corporation tax are living in a fantasy land—in the short term, at any rate.

Q461 Lord McFall of Alcluith: The question of how much fiscal latitude Scotland would have has been mentioned. Do you think that fiscal rules would be necessary both for the rest of the UK and for Scotland to limit the risk being taken?

Professor Iain McLean: Yes. An independent Scotland would have to have conservative fiscal rules: first, as a matter of simple prudence; secondly, because its debt has to be credible so as not to attract penal rates; and, thirdly, because it would be in negotiations with the EU, which would, on current arrangements, require it to meet the Maastricht criteria. That would therefore imply that an independent Scotland must have conservative fiscal rules, which might indeed look somewhat like Prime Minister Brown's fiscal rules, but I cannot see further into my crystal ball than that.

Q462 Lord McFall of Alcluith: In your experience, have similar fiscal rules for limiting sovereign debt and borrowing in other countries worked?

Professor Iain McLean: Have they worked? That is a question beyond my expertise, I am afraid. I merely observe that there is chaos in a number of EU member states which purportedly have had fiscal rules but in fact have not.

Q463 Lord McFall of Alcluith: To add to that, do you think it would be feasible to design and police such rules so that they would be effective, or is that just adding to the last question that chaos rules in the EU?

Professor Iain McLean: If I were John Swinney and if he were the first Finance Minister of an independent Scotland, I think I would beat a path to North Queensferry, knock on Gordon Brown's door and say, "Please could you tell us how you devised and policed the golden rule and the sustainable investment rule, and how you would organise them if you were doing it again?". In my view, there was nothing wrong with those as rules. What was

wrong was the implementation of them in the latter years of the British Labour Government.

Q464 Lord McFall of Alcluith: Do you think there would be any friction in that relationship with fiscal rules and a fiscal pact?

Professor Iain McLean: There might be friction between the Scottish Chief Secretary to the Treasury and the rest of the Scottish Administration, but that would happen in any—

Q465 Lord McFall of Alcluith: In other words, how much fiscal latitude would there be for Scotland if it signed up to fiscal rules? It would have to have conservative fiscal policy not dissimilar to the rest of the UK.

Professor Iain McLean: Very little. On the current GERS numbers—of course, that is now and not in two years' time—to achieve a fiscal balance Scotland must either increase taxation or reduce services or both. That is even on the assumption most favourable to the Scottish Government that oil revenue remains buoyant.

Q466 The Chairman: Perhaps I could come in on the oil revenue point. A number of our witnesses have suggested that, apart from the declining oil revenue, the real issue is its volatility. In the situation that you are describing, volatility of a major source of revenue would be a serious issue heavily affecting the fiscal rules.

Professor Iain McLean: I agree, and that is an issue which is urgent for Scottish Ministers to address. All I can do is agree with you that it is a big issue. Current Scottish Ministers, notably in the last Scottish election, were, if I may say so without being rude, intent on spending the oil revenue twice—first, as a sovereign wealth fund and, secondly, to fund current spending. I would hope that before the referendum the actual intentions of those who would like Scotland to be independent are disentangled on this point.

Q467 Lord Forsyth of Drumlean: Is it really a problem for Scottish Ministers if they go on a spending binge based on a high oil price and the revenue disappears because the oil

price falls? Would the position not be rather analogous to having a large bank in your economy? To what extent would an independent Scotland be too big to fail from the point of view of the Treasury and the rest of the UK? Although you might have fiscal rules, in practice the rest of the UK Treasury would have a pretty strong interest—would it not?—in bailing out an independent Scotland if it got into financial difficulty. Should the Treasury be thinking about this problem, which, as I said, I would characterise as an independent Scotland being too big to fail? With regard to the notion that we can agree some rules with an independent Scotland and that will be fine, and if they break the rules, so what, would that have not have a knock-on effect on the rest of the UK?

Lord McFall of Alcluith: Looking at paragraph 42 of your written evidence, are you not agreeing with that when you say, “The extreme volatility of North Sea Oil revenue poses a serious problem for Scotland but none for the RUK unless Scotland approaches fiscal collapse *a la* Greece”. That is really the point that you are making with regard to Lord Forsyth’s point.

Professor Iain McLean: Yes, but I do not see fiscal collapse *à la* Greece as occurring very quickly. I see this as less of a threat—again, taking an RUK perspective—than I do the issues of financial and monetary regulation. If Scotland, having by hypothesis adopted a set of fiscal rules, then fails to observe its own fiscal rules, the first people to notice will be creditors—holders of Scottish debt. There will be an instant reaction in terms of bond yields, and that will be an instant warning to the Scottish Government that they have to do something. So possibly my paragraph 42 was a little overwrought. I do not see this as posing an immediate threat to financial stability in the rest of the UK, whereas I do see the risks associated with financial regulation as an active, live threat. I would certainly see this as being a threat to the fiscal balance of Scotland, and that will be for the Scottish Government and the Scottish people to deal with. To the extent that independence involves a grown-up discussion about

balancing the books, which has not taken place in Scotland since 1707, one could say that that is perhaps the best argument for Scottish independence, but that is perhaps rather outside my brief.

Q468 Lord Rowe-Beddoe: Professor McLean, you refer in your written submission to expert academic evidence on the economic consequences of previous splits, and you specifically talk about the Republic of Ireland and Czechoslovakia. Could you summarise that evidence for us and highlight similarities and differences with the Scotland case that we might consider?

Professor Iain McLean: Yes, with pleasure. I think the headline summary is that there was acute disruption in both cases but, after a while, the situation settled down and there has been no lasting damage. In the case of Slovakia—here I am summarising Dr Henderson's view rather than offering you my own—there was an immediate reality check. The Slovak currency was not credible at par under the then Slovak Government, which negotiated independence. A change of government in Slovakia in 1998 led to the external credit rating of Slovakia going above that of the Czech Republic and led to the sequence of events such that, for better or for worse, Slovakia is now in the eurozone and the Czech Republic is not. So I think it would be hard to say that there were long-term deleterious consequences of that particular split.

In the Irish case, we have to take a longer view and it is a rather difficult one to take, as immediately after independence the Irish economy was devastated by civil war. It was then rebuilt by the party which won the civil war—the Free Staters, as they were then. When you then had a change of government to the party which had lost the civil war—de Valera's party—in 1933, that party took Ireland in a very autarkic, isolationist direction, where essentially it stayed for 40 or so years until the Garret FitzGerald Government in the 1980s. But I would regard that as domestic Irish policy choices. No doubt the Irish economy would

have grown somewhat faster if it had not experienced the protectionist turn that was taken under de Valera. In the very long term, I do not think one can say that Ireland has either suffered or benefited compared with what would have happened counter-factually if it had remained in the UK in 1921. So I think that the long-term consequences are possibly rather small—smaller than the short-term consequences.

Q469 Lord Rowe-Beddoe: Can I go back for a moment to Czechoslovakia? You referred to it and other witnesses have told us what the intention was. I am talking about the timeframe in which it is envisaged that negotiations will take place to satisfy both sides of the division. Some of the witnesses who have appeared before us have suggested four or five years. But in Czechoslovakia they threw all their toys out of the pram and they were away in some three months. I would assume that the consequences of the way they split have been clearly in favour of the Czech side rather than there being any form of equality between the two.

Professor Iain McLean: I think probably not. The split enabled the two countries to go their own ways and to run their economies in the ways which seemed to suit the Governments and the people of the two countries. After all, they are both among the most successful of the successor states to the former communist regimes in central Europe. I could give you a slightly more detailed answer but I think that, to save time, I should simply refer you to an excellent paper which Dr Henderson has written as a briefing note for the Political Studies Association, which, again, I will notify the clerks of.

Q470 Lord Rowe-Beddoe: Thank you. We are different from Czechoslovakia. This is RUK, so there are three distinct nations involved in the rest of the UK. Can we learn anything from Canada, which has debated such a move on many occasions, as has Catalonia in Spain? Can we learn anything from why there was hesitation to take such a move?

Professor Iain McLean: I have to be cautious in this answer because there are academic experts on both those territories in UK universities and I am not a specialist in either. In the Canadian case, there were the two Quebec referendums in 1980 and 1995. As has already been alluded to this afternoon, the result in 1995 was very close indeed. I think that when it was known in advance that it was likely to be very close there was some business disruption. Since then, what I have perceived just from casual observation is the same as I perceived in the Czech Republic/Slovakia case. Quebec has not in the long term suffered from the events of 1995.

As to what the Canadian federal Government did about the threat of Quebec's secession and how they saw their way to heading it off and so on, that could be the subject of another entire afternoon's evidence. I could come back and do it but I would rather nominate somebody who would be more expert than me.

In the case of Catalonia, it is a little hard to draw helpful analogies, one reason being that all the Spanish regions have some fiscal autonomy at present. However, none of them has as much fiscal autonomy as would accompany independence on whatever terms it was negotiated. The situation is somewhat easier for the Catalans because it is one of the richest regions of Spain, whereas Scotland is an average—Wales and Northern Ireland are poorer than average—region of the UK.

Q471 Lord Tugendhat: You make a number of references to Ireland, which of course is understandable because it is a part of the United Kingdom that hived off. Apart from the differences to which you have referred—the civil war and so forth—it seems to me that there is one aspect of the Irish experience which the Scots would not wish to replicate, and that is that emigration remained very high. It had been high before independence and it continued to be high. The more autarchic the de Valera Government became, the more emigration increased. To the extent that the Irish sought to differentiate themselves from

the United Kingdom, their population diminished, and that is of course the reverse of what the Irish independence movement would have hoped for. I make that point not because I want to draw any parallels at all—the situation is quite different—but because it seems to me that Irish examples are really not very valid when considering the Scottish experience.

Professor Iain McLean: Ireland in 1921 was a deeply rural and underdeveloped economy. Even with the best economic policy that would have been available to any policy-maker anywhere in the world in 1921, emigration might have continued. It is probably common ground that policy mistakes were then made, notably by the de Valera Government, and not reversed for many decades until the turn to a truly open economy under the FitzGerald Government in the 1980s. So I think it would be hard to draw any analogies with Scotland, which is not an underdeveloped agricultural economy. One hopes that politicians will not make easily avoided policy mistakes after independence.

Q472 The Chairman: Could I just go back to a point that you made in response to Lord McFall about paragraph 42 in your paper, on which I have been reflecting? We have talked in terms of robust negotiations on financial institutions and financial regulation but, in the event of extreme volatility of North Sea oil revenue, is it not likely that it is the lender of last resort issue which will really matter most in these negotiations? You say, “As negotiators will all be aware of the fiscal risk ... they will have an incentive to design robust institutions”. Do you not really mean that the rest of the UK negotiators are most at risk and therefore will most insist on robust institutions?

Professor Iain McLean: That is what I intended to convey and I am sorry if I was not clear in my earlier answers on that point. I assume that the rest of the UK negotiators will, on independence day, observe that oil revenue for Scotland is three things: volatile, in predicted long-term decline, and barely adequate to make the difference between Scottish expenditure and Scottish tax revenue on independence day. Given that the rest of the UK negotiators

will notice that it has all those three properties, that will incentivise them to insist on whatever firewalls they think will work to protect the rest of the UK from a Scottish collapse. That is what I intended to convey in that paragraph and I am sorry if I was not sufficiently clear in earlier answers.

Q473 Lord Forsyth of Drumlean: My difficulty with that answer and the previous discussion is that I cannot think what the firewalls would be in practice. If things go wrong in Scotland, what are they going to do about it? They will have to come to the rescue because there are so many trade and other relationships across the border. It is a bit like the position in which we found ourselves in 2008 when the major banks got into difficulty. Everybody said that the taxpayer should not bail them out but actually we did not have a choice because the system depended upon it. When you say, “whatever firewalls”, what would the firewalls be that protected us in England?

Professor Iain McLean: For this scenario, we are assuming that Scotland would have its own interest in having conservative fiscal rules. If, for any unaccountable reason, the Scottish negotiators failed to volunteer that they would adopt a very conservative set of fiscal rules, the rest of the UK negotiators and also any EU negotiations which an independent Scotland got into would do the insisting for them. So I come back to my earlier answer to you, Lord Forsyth, which is that any failure to balance the books because of declining oil receipts would be a slow-burn crisis. It would not be an instant crisis like the Slovak currency in January 1993; it would gradually become apparent that the Scottish Government were failing to balance their books, and that would have all the consequences that we all know, but I do not see that they would be instant consequences. Perhaps putting Greece in that paragraph was overheated on the grounds that one aspect of the Greek crisis arose because it was discovered that the Greeks were cooking the books, and I do not think that that would be an analogous situation in Scotland.

Q474 Lord Hollick: You mentioned at the beginning of the session that it would be highly desirable if a number of these issues were addressed before the referendum took place. I want to pursue that a little bit further. I think that we have identified, certainly on the financial side, that uncertainty would be the enemy, and markets can take their revenge quite quickly. From a practicable point of view, notwithstanding the fact that the referendum is not the moment of independence but it presages independence, is it not the case that these issues would have to be addressed pretty clearly so that financial markets knew where they were? That would require not only a declaration by the proponents of independence that they would intend to use this or that currency; it would require a degree of bilateral discussion with the United Kingdom so that in fact, at the point of the referendum, financial markets and those people voting would have a clear idea of how these very serious issues, which can undermine an independent Scotland very quickly, could be addressed.

Professor Iain McLean: I can certainly see the force of that. I understand that UK government spokesmen have said that they are not prepared to negotiate about hypotheses which may never come to reality. That, I believe, is the current stance of the UK Government, so I would hope that you would put that question to Ministers rather than to me.

Q475 Lord Forsyth of Drumlean: Related to this but turning to the issue of EU membership, which you have just touched on, the first question is: do you think that Scotland would have to reapply for EU membership? I think that the answer to that is yes. What do you think would be the main differences that would arise from a Scottish perspective as a result of joining the EU? Would, for example, the opt-outs which we enjoy on the euro and so on necessarily be lost? What is your view?

Professor Iain McLean: I have to be cautious in answering that question, Lord Forsyth, because I am not a lawyer and the question you have asked is partly a legal question. There

are well-known experts in Scotland on that precise subject, such as Professor Adam Tomkins of the University of Glasgow and Professor Neil Walker of the University of Edinburgh. I hope that the Committee will ask them that precise question. Members will be aware that there was a recent House of Commons Library report³ which covered those issues on the legal side. So my answer to your first question as to whether it would be a matter of a separate negotiation is: probably, but do not take my word for it. My answer as a political scientist is that on the EU side a Union in trouble is not, at the end of the day, going to throw out 5 million of its existing citizens, so in the end there will be an agreement. However, I think that the likeliest sticking point is precisely the one that Lord Forsyth has just identified, which is: would Scotland get a share of the current UK rebate? I am pretty clear that the answer to that is no.

Q476 Lord Forsyth of Drumlean: What about the currency issue? My understanding of the rules is that ultimately Scotland would have to join the euro, if not necessarily immediately.

Professor Iain McLean: That is also my understanding of the rules, but it does not seem to have troubled policy-makers in Sweden for the, by now, quite substantial number of years in which that has nominally applied.

Q477 Lord Forsyth of Drumlean: But there is a more immediate issue, which is the size of the deficit that was being run by the country. Scotland's budget, based on the current numbers, would seem to imply that there would have to be some reduction in public expenditure or some increase in taxation in order to meet the rules. Is that right?

Professor Iain McLean: This goes back to my earlier answer to Lord McFall. I think that a Scottish Government would have to offer the world some conservative fiscal rules, which I think would carry the implication of either more tax or less spending or both.

³ A. Thorp and G. Thompson, Scotland, Independence and the EU Standard note SN/IA/6110, Nov 2011

Q478 Lord Forsyth of Drumlean: So, everything else being equal, although Scotland would be able to join the EU, that would mean that it would have to either find some savings or increase taxation.

Professor Iain McLean: I think I would agree with that, while not claiming to be an EU expert.

Q479 Lord Forsyth of Drumlean: One other question. Do you think Scotland would be better off in the EEA?

Professor Iain McLean: I do not see that it would really make any difference. I cannot see that it would be better for Scotland. The EEA, likewise, would surely insist on conservative fiscal rules and on a credible currency. If it is in our minds that the Scottish Government might say, "Oh well, if you won't play the game, we'll go to the EEA instead", I do not think that that would be seen by the European Commission or the Council of Ministers as a credible threat, so I do not think that it would make any real difference.

Q480 Lord Forsyth of Drumlean: So, to sum up without putting words in your mouth, whichever route one goes, there is going to have to be some degree of fiscal discipline.

Professor Iain McLean: If the GERS numbers for the fiscal year 2014-15 were similar to those that we have now.

Q481 Lord Forsyth of Drumlean: And, given that we have agreed that the oil price is very volatile, it would seem that the scope for domestic expenditure or for maintaining a stable tax system would be very much driven by the oil price.

Professor Iain McLean: I would agree with that, yes.

The Chairman: We have had a most interesting afternoon, Dr McLean and Mr Ingram, and thank you very much indeed for coming.

Professor Iain McLean: Thank you very much for inviting us.