SCOTLAND'S ECONOMIC FUTURE

EDITED BY PROFESSOR SIR DONALD MACKAY

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CONTENTS

LIST OF TABLES AND FIGURES

BIOGRAPHIES

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John Kay is a visiting Professor of Economics at the London School of Economics, a Fellow of St John's College, Oxford. He is a Fellow of the British Academy, a Fellow of the Royal Society of Edinburgh and a member of the Scottish Government's Council of Economic Advisers. He is a director of several public companies and contributes a weekly column to the Financial Times. He is the author of many books, including The Truth about Markets (2003) and The Long and the Short of It: finance and investment for normally intelligent people who are not in the industry (2009) and his latest book, Obliquity, was published by Profile Books in March 2010.

PROFESSOR DAVID SIMPSON

David Simpson graduated in Economics from Edinburgh University. He received his Ph.D. from Harvard, where he was research assistant to Wassily Leontief. After a spell in the Statistical Office of the United Nations in

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David Simpson is the author of several books, and has published numerous articles in periodicals ranging from Econometrica and Scientific American to The Financial Times and The Spectator.

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PROFESSOR DAVID BELL

David Bell has a First Class Honours degree in Economics and Statistics from the University of Aberdeen, an MSc in Econometrics and Mathematical Economics from the London School of Economics and received his Ph.D from the University of Strathclyde. He has served as a Professor of Economics at the University of Stirling since 1990, having previously held positions at the University of St Andrews, University of Strathclyde, University of Warwick and Glasgow University. David Bell has also acted as an adviser and consultant to a range of organisations including the Finance Committee of the Scottish Parliament, The Cabinet Office, World Bank, Royal Bank of Scotland and Scottish Enterprise.

David Bell has written a large number of articles for a range of journals and newspapers and is a regular contributor to The Scotsman.

JIM & MARGARET CUTHBERT

After lecturing in statistics at Glasgow University, Jim Cuthbert joined the United Kingdom civil service in 1974 and worked in statistics in the Scottish Office and the Treasury. He was latterly Scottish Office Chief Statistician.

After leaving the civil service in 1997, he has pursued a number of interests, including research and consultancy. His research is particularly in the areas of Scotland's public finances and the Scottish economy and in certain aspects of purchasing power parities. Particular interests have been in the analysis of government expenditure and revenues in Scotland (GERS), the performance of PFI schemes and developing alternatives to current models for utility charging.

Margaret Cuthbert has lectured in economics at several Scottish universities, but spent most of her career as an economics and business consultant. Her major area of research has been public expenditure in Scotland. She edited and contributed to "Public Expenditure in Scotland", one of the few economics texts on Scotland written in the period after the first devolution referendum. Specific interests include GERS, and the improvement of the GERS data and analysis: critiques of the private finance initiative: the analysis of devolved and reserved spending: and research into the basis of the costings of the policy of free care for the elderly.

PROFESSOR ANDREW HUGHES HALLETT

Andrew Hughes Hallett holds joint appointments as Professor of Economics at George Mason University's School of Public Policy in the US and at the University of St Andrews. His interests lie in macroeconomics and policy. He is ranked in the top 1% of economists world-wide, has held appointments at Princeton, Rome, Berlin and Paris Universities, is consulted by the European Central Bank, IMF, World Bank, and sits on the Scottish Government's Council of Economic Advisors.

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Keith Skeoch is the Chief Executive Officer at Standard Life Investments and a main board director at Standard Life Plc. He has over 30 years experience in financial services and capital markets and was Chief Economist at James Capel & Co and HSBC Securities before joining Standard Life Investments in 1999. He chaired the ABI Investment Committee and Institutional Shareholder Committee from 2007 – 2010. He is currently on the board of the Investment Management Association as well as HDFC Life and HDFC Asset Management in India.

He was awarded an honorary doctorate by Teesside University for services to investment management and his contribution to the stewardship debate.

The views expressed in Keith Skeoch's paper are the personal views of the author and should not be taken as representing those of Standard Life Plc.

PROFESSOR ALEX KEMP OBE

Alex Kemp is Professor of Petroleum Economics and Director of the Aberdeen Centre for Research in Energy Economics and Finance at the University of Aberdeen. For many years in his research he has specialised in petroleum economics with special reference to the North Sea and has produced over 200 papers and books in this area. His first paper was published before the first oil was achieved in the North Sea. From 1980 to 1992 he was Specialist Adviser to the House of Commons Select Committee on Energy. From 1993 to 2003 he was a member of the Energy Advisory Panel to the UK Minister for Energy. From 2007 to 2011 he was a member of the Council of Economic Advisers to the Scottish Government. In July 2011 he was appointed a member of the Scottish Energy Advisory Board to the Scottish Government. In 2006 Professor Kemp was awarded the OBE for service to the oil and gas sector. In September 2011 The Official History of North Sea Oil and Gas commissioned by the UK Government and written by Professor Kemp was published in 2 volumes.

BEN THOMSON

Ben Thomson has been an investment banker for 25 years, starting his career at Kleinwort Benson and moving to Noble Group in 1990, where he became Chief Executive in 1997 and Chairman from 2007 until 2010. He founded and is Chairman of Reform Scotland, the independent think tank researching and promoting policies to improve the Scottish economic environment and the effectiveness of the public sector. He is also Chairman of Urbicus Ltd, a fund management company, Chairman of Inverleith Capital LLP, a corporate finance firm, Chairman of the National Galleries of Scotland, and Chairman of Barrington Stoke, a Scottish children's publishing company. He is a Director of the Edinburgh International Science Festival, Martin Currie Global Portfolio Trust and Fidelity Special Values. Ben has a degree in Physics from Edinburgh University.

PREFACE

In 1977 I edited a book, 'Scotland 1980: the economics of self government,' which included contributions by a number of economists. The publication was funded by BBC Scotland and The Scotsman. The format adopted here is similar but not identical. For example, in the 1977 publication each author was given a wide subject area to discuss - here, after the introductory chapter, each author was asked a specific question in order to give greater focus to the discussion. The authors have responded admirably to the challenge.

In this instance, it was thought highly desirable to include a number of authors with established business experience. But all the authors are acknowledged as authorities in their chosen subject areas. For the avoidance of doubt, I would emphasise that no author was chosen on the grounds of party affiliation. Some have been or are members of political parties, but for most they have no party allegiance or it is unknown to me. What has mattered is that each author has demonstrated an ability to analyse and report independently on their chosen area and on the evidence. Each author(s) has been solely responsible for their own text. As editor, I have read all the initial drafts and commented on most of them. This has been largely directed at providing a consistent structure for the reader. Any agreed changes were of a minor nature and did not alter the thrust of the initial draft.

My introductory and concluding chapters have gone through a similar process. The initial drafts were forwarded to all the contributors. I found their suggestions very helpful and amended the text when this was appropriate. All, or various parts of the text, were read by individuals who gave of their time to provide information and more general guidance. I alone am responsible for any remaining errors or omissions.

I am a member of the Advisory Board of Reform Scotland who publish this report and under whose auspices the work of the authors was organised. Ben Thomson and Geoff Mawdsley of Reform Scotland have made particularly valuable contributions, the first as one of the authors and the second as a guide and mentor - to the editor in particular!

At the time of the 1977 publication it was not certain that devolution would occur (and it didn't until 22 years later) and, as was stated in that publication, ‘In economic terms devolution was deliberately designed to maintain the status quo.’ So it was and is, but that appears to have been a serious weakness which will be tested in a referendum. The economic arguments have changed very little over time, but the political framework has. The referendum will not and should not be decided on economic grounds alone but, as against the 1979 and 1999 referendums, the option or options posed will have important implications for economic policy and that forms the subject matter of this book. So this is an exercise in political economy as befits the country which gave birth to that concept.

Sir Donald MacKay

CHAPTER 1
THE FRAMEWORK, THE AUTHORS AND HOME RULE

BY PROFESSOR SIR DONALD MACKAY

INTRODUCTION

In Shakespeare's 'Macbeth'–'the Scottish play' - Macduff poses the question, 'Stands Scotland Where It Did?' The answer was not historically accurate and even less reassuring:

'Alas poor country!
Almost afraid to know itself. It cannot
Be call'd our mother, but our grave.'

The play depicts Macbeth as an anti-hero, but historians see him as having been a strong and popular king. 'Macbeth' was written just after the Union of the Crowns in 1603. The period, from then to around 1750, encompassed the Act of Union in 1707 but it was not a happy time in economic, social or political terms. Yet, it was in this period that the Scots built on the foundations of an educational system, without which the intellectual, social and economic changes post-1750 would not have been possible. The Act of Union, giving access to English markets and a growing Empire and family of colonies, provided an economic framework which allowed and encouraged the transformational economic and social developments of the Agricultural and Industrial Revolutions. The leading figures of the Scottish Enlightenment knew this well. They paid the English the ultimate compliment of believing that they offered much to admire and learn from, but had a good conceit of their own ability to "out-English the English." And the terms of the Act of Union explicitly recognised the special place in the life of Scotland then enjoyed by the law, the kirk and a distinctive educational system.

The first two decades of the 20th century saw the peak of Scotland's relative prosperity, both in a UK and international context. The economy was dominated by the heavy industries of shipbuilding and marine engineering, steel production and coal mining, none of which were well suited to the world of recession, slow growth and rampant protectionism which emerged from the 1920s. Nor could Scottish industry compete effectively with the "new industries" of the 1930s largely dependent on the UK market. The remaining rump of the heavy industries found it difficult to contribute effectively to the new growth of the international economy after the Second World War, as a number of emerging economies had a better raw material base, lower labour costs and stronger domestic economies. As in the interwar period, structural change was slow in the production industries and tradeable services. The most significant changes were the growth of financial services, the attraction of electronics-based businesses through inward investment, the creation of new private businesses from denationalisation and the new activities introduced by the development and production of North Sea oil and gas.

But the underlying economic problem still remains and it is structural in nature. The critical feature is a low business birth rate compared with England and the Scandinavian economies. This problem is longstanding and predominately social and cultural in origin, as witness David Bell's chapter which shows that, within Scotland, the business birth rate is particularly low in the more densely populated Central Belt, above all in the west. It is also a problem in the political economy sense. Scotland has a persistent and growing trade deficit with rest of the UK - an inevitable concomitant of high levels of public expenditure supporting a relatively large and inefficient public sector. This has never convinced the political parties in Scotland, or the bulk of her population, that more public expenditure is a sticking plaster and not a solution to a poor economic performance, unless it is directed to encouraging a higher business birth rate and a more dynamic market sector, the chief driver of economic growth.

The political element of our political economy has changed in another sense, with the election of a SNP majority in the Scottish Parliament. The electoral system was designed to make this outcome extremely unlikely, but it appears that the electorate believed that the minority SNP government in 2007-2011 performed rather better than the Lab/Lib Dem Coalitions of 1999-2007. As of now, all the parties appear to believe that a higher proportion of Holyrood's expenditure should be funded directly from Scottish taxpayers but they are all struggling to articulate what greater devolution, home rule, independence lite or independence might mean - and some or all of these may have to be considered in the referendum which lies ahead.

The remainder of this chapter develops as follows:

- the contribution of each author(s) is summarised
- the major economic issues are discussed, particularly those which would shape economic policy in a home rule/independence lite context, followed by
- a short final summary.

THE AUTHORS

Here, I attempt an overview of the issues raised by each author. Each has seen my summary, but I remain responsible for this text. The final chapter will demonstrate that the contribution of each author has influenced my overview and conclusions.

John Kay (Chapter 2) suggests that Scotland's economic performance has been 'mediocre' by general European standards and much the same comment could be applied to most of the time since 1920. He concludes that 'It is easy to imagine Scotland as a standalone economic entity', but political independence would have to recognise that Scotland would have a high degree of economic interdependence with the RUK. Thus, imports and exports from/to the RUK may account for some 70% of Scottish national income. Public expenditure per capita has been higher for Scotland than the UK average but, too often, has not provided value for money - particularly with respect to the transport infrastructure and social housing expenditure. He concludes that 'Scotland is the victim of an institutionalised community failure which was created within Scotland and has proved resilient even in the face of determined attempts to overcome it.'

David Simpson looks at the performance of the Scottish economy compared with a peer group of 18 Western European economies. He observes that size and economic growth may be inversely related and then considers the recent experience of that "Celtic tiger" economy, Ireland. The Irish experience is that fiscal policies - especially lower corporate taxes - can transform the economic performance of a small economy which is open and welcoming to inward investment and has access to wider European markets. However, although the fiscal framework was appropriate, 'A domestic speculative boom, in this case housing, was inevitably followed by an equally spectacular collapse of the banks that had so recklessly financed the boom.' He concludes that 'the main driver of a market economy …..is the amount and quality of its private investment' and adopts the view of Keynes that 'animal spirits,' or what David Simpson calls 'confidence' is the key determinant of private investment. He concludes 'that small is still beautiful.'

Jim and Margaret Cuthbert begin their analysis with the GERS report which estimates the amount of government expenditure undertaken on behalf of Scotland and the tax revenue attributable to Scotland, comparing the resultant fiscal balance with that for the UK as a whole. They demonstrate that both the arithmetic and the methodology is open to serious criticism and appropriate adjustments would reduce the fiscal deficit shown for Scotland relative to the UK. Nonetheless, on the GERS definition of Scotland's economic boundaries she has run a larger deficit or smaller surplus relative to the UK. The importance of offshore resources complicates the matter. The Geneva Shelf Convention determining the tax jurisdictions in the North Sea favoured the littoral states with long coastlines and small populations. Had Scotland been an independent state, she would have benefited substantially. Both the Cuthberts and Joseph Stiglitz have observed that some significant part of North Sea oil and gas reserves should fund capital investment, for example, in renewables. But the main point the Cuthberts make is that the annual sterile debate on GERS will continue until a full set of national accounts is produced covering all trade and financial flows in to and out of Scotland, defining the latter in accordance with the manner in which the littoral states of the North Sea have been treated as per the Geneva Shelf Convention.

Drew Scott points out that, under the Scotland Bill, the block grant which currently funds the Scottish Government's expenditure would be reduced by the amount of tax revenue raised by a new Scottish rate of income tax. The grant element might fall by some 15% so that the block grant would 'continue to represent the lion's share of income accruing to the devolved administration.' Scott suggests that the Holtham Committee, set up to review funding options for the Welsh Assembly, considered that enactment of the Scotland Bill would 'leave Scotland's budget exposed to tax revenue risks that are not associated with any decision taken by the Scottish Parliament.' Most important of all, the proposals fall far short of full fiscal responsibility as the block grant would remain the main element in the funding of Holyrood. Scott believes that this would be unlikely to change present behaviour, especially as there is apparently no proposal to increase the range of economic policy powers available to the Scottish Government. Hence his judgement is 'that while the Scotland Bill might not exactly be a 'cul de sac,' most certainly as it presently stands it does not point the correct way forward.'

David Bell describes the dismal trends evident in the Scottish economy and the failure of economic policy to contribute anything significant to their resolution.

The trends are:

- over 1998-2008 manufacturing exports from Scotland fell by 17% while they rose by 72% in the UK, 176% in Germany, 100% in France and 95% in the US.
- in 2010 Scotland accounted for 6.6% of UK manufacturing employment, well below its population share of 8.8%.
- in manufacturing 'Our costs, particularly wage costs, are too high, our technology is not good enough, our business environment is deemed less attractive than elsewhere or Scottish goods are denied access to foreign markets.'
- 85% of the 212.9 thousand growth of employment in Scotland over 1995-2008 was in Health and Social Work, Education and Administration, Defence and Social Security - predominantly jobs in the non-market sector. As David Bell remarks 'this is clearly not a sustainable long-run growth path for the Scottish economy.'
- …'Scotland's record of business spending on research and development is extremely poor and it is difficult to see how it can extend the range of its comparative advantage unless this record improves.'
- 'Some aspire that Scotland join the social democracies of Scandinavia, citing their widespread provision of non means-tested welfare benefits' …but…. 'these welfare benefits are supported …..by a very strong small business culture.' The business birth rate is stubbornly low, particularly in the Central Belt where the great bulk of the population is located . 'Thus, Scotland had 26.5 enterprises per 1000 population in 2008. Denmark, Norway, Sweden and Finland had 43.4, 57.1, 67.3 and 61.2 respectively.'

Andrew Hughes Hallett considers three alternative monetary arrangements available to an independent or sovereign Scottish government:

- membership of a currency union (the existing UK union or the Eurozone)
- a currency peg to an outside currency
- complete monetary independence

He suggests that a currency union will be most effective when the partners (a) trade extensively with each other (b) experience high capital mobility between each other (c) have high labour mobility or wage flexibility and (d) have a high degree of 'symmetry in shocks and market or institutional structures'. He concludes that 'Eurozone membership or full monetary independence are actually less likely (than staying within the sterling area) to be advantageous for Scotland on purely economic grounds' and that 'staying with Sterling has its costs; but the costs of dumping the sterling link in favour of the G-7 or the Euro are likely to be higher, at least at this stage.' Given the recent travails of the Eurozone we might all say "hear, hear" to that!

John Kay's second contribution is particularly relevant to Andrew Hughes Hallett's view that 'a properly functioning banking system … is an essential component in any monetary regime' this implying 'that a local banking system, and a hand in its regulation, will be needed to make monetary policy effective.' John Kay estimates that the liabilities of the two "Scottish banks" which were rescued by the UK government (the Royal Bank of Scotland and Halifax Bank of Scotland) were some 30 times Scottish GDP. These liabilities were far greater than those which could have been guaranteed by any Scottish government (for which read the Scottish taxpayer). But, John Kay argues, the UK government should never have underwritten all the liabilities of the "Scottish banks" because the Scottish (or the UK) taxpayer has no moral or legal obligation to underwrite all the liabilities incurred by private institutions. Of course, the central bank has long assumed the responsibility of acting as lender of last resort against good security, but this was intended to apply as a guarantee only of the retail bank deposits on which clearing banks pyramid credit. It was not the intention to apply the same principle to financial conglomerates which willingly embraced a clash of cultures resulting in the greatest financial crisis since the 1930s and much of whose liabilities were not those of the Scottish people (or the people of the UK) either morally or legally.

Keith Skeoch sketches the long and innovative history of the Scottish financial institutions and reviews the experience of the turbulent period from 2007. He observes that the impact of the banking crisis on the wider economy has been much less than expected, possibly for two reasons. First, though both RBS and HBOS were headquartered in Scotland, the asset quality and liquidity problems that contributed to their collapse were much more diverse and arguably had very little to do with regional location of their headquarters: and, second, other large and important financial services sectors - insurance, fund management and support services - have continued to 'thrive despite the (banking) crash.' The financial service sector has 'robust and resilient critical mass.. (and) ..is a core component of the Scottish economy and a critical connection with the rest of the world. In a small economy, however, 'Policy needs to be driven by attracting global talent and businesses in the capital light area and also accept that a low tax environment is likely to be a critical driver for its future success.'

Alex Kemp suggests of North Sea oil and gas that 'it is the composition of the value added in the sector which makes its contributions to the national economy unique and adds an extra dimension to the policy issues.' In the early 1980s 'the UK balance of payments was transformed compared … (with)… the position for much of the 1960s and 1970s.' But the very scale of these impacts and their distribution resulted in sharp political and social tensions. Sir Michael Edwardes suggested it might be better 'to leave the bloody stuff in the ground,' while the SNP suggested 'It's Scotland's oil.' Kemp observes that applying between 'Scotland and the UK the median line….employed to determine the line of demarcation for fisheries management purposes' would have placed the bulk of tax revenues within a Scottish jurisdiction. Of course, this is past history but he points out (a) while North Sea tax revenues can be expected to continue to decline they will (b) continue to be substantial for a long forward period and (c) as the oil resource is not renewable these revenues 'could play a useful role in preparing local economies for the post-oil era.' For example, the real value of tax revenues over the next ten years in the "Scottish sector" of the North Sea might be expected to be in the range of £5-10 billion per annum and would remain substantial, although variable, over a much longer period.

Ben Thomson suggests that it would not be sensible to create a Scottish Exchequer if the Scotland Bill were enacted as 'it would not be viable to do anything more than expand the current Finance Department of Scottish Government to handle the additional powers'. Home Rule and independence are quite another matter as they each would require a Scottish Exchequer working alongside a Scottish Policy Unit and a Regulatory Department. In the latter circumstances, there are clear advantages in starting with a clean sheet of paper as, above all, it allows a new system 'that is shrewd enough to borrow the best of other systems and learn from the mistakes of others.' He concludes that an effective Scottish Exchequer should be driven by four principles - integration, simplicity, transparency and efficiency. Under a Home Rule scenario, he recommends that the major functions of the Exchequer would be setting tax and revenue, tax and revenue collection, setting maximum national debt levels, controlling government expenditure, and accounting and audit.

HOME RULE

In my editorial contribution to the 1977 publication, I suggested that two extreme views dominated the political economy discourse of that time. The first was that 'the Scottish economy was so weak and dependent on England that self-government would result in serious economic disadvantage' and, the second, 'that Scotland's difficulties were somebody else's fault, specifically the result of the political union with England.' I suggested that 'It would be difficult to take either argument seriously were it not for the fact that each is accepted by a significant part of the Scottish community.' The same polarised views are still evident today and the same comment applies.

In the late 1940s and the 1950s, many of the more interesting political discussions in the Highlands centred round Home Rule for Scotland - both as to how it might be structured and what it might achieve. The leading proponent of home rule was the, then, Liberal Party - this reflecting its support for Irish home rule in the 19th century. Today, it appears that Lord Steel still remains attached to the idea and in the party structure of the Liberal Democrats there are still echoes of this past, as witness the Federal Executive and Federal Liberal Democrat Conference. Moreover, the Lib Dem MSPs at Holyrood and their MPs at Westminster act within a federal framework unlike the other unionist parties - although it is possible this might be changing for the two largest opposition parties represented in the Scottish Parliament. Early in the last century, Keir Hardie, the first independent Labour MP was a proponent of home rule although the Labour Party now seem to be of a very different view. Historically, the Conservative Party has been the most consistent pro-union voice, but Sir John Major has suggested that 'all responsibilities except foreign policy, defence and management of the economy' should pass to the Scottish Parliament.

This division of powers between different tiers of government is what was envisaged by home rule parties but, in recent years, modern unionist parties have treated home rule as if it were, in constitutional terms, just an extension of devolution, so-called 'devolution max.' Devolved government is not home rule government. Under devolution, powers are handed down by ordinary legislation of the Westminster Parliament and can be changed by ordinary legislation. Hence, the commonly expressed view that "power devolved is power retained." However, historically, home rule was seen as a structure which defined the federal area of competence and left the rest to state or provincial parliaments - the home countries being the evident British equivalent. Within a federal system, it is common practice to entrench the powers of the states or the provinces which means that they can only be changed with the prior assent of the latter. That is, at each of the two levels the parliaments or legislatures were sovereign or independent in their defined fields of competence. This is the concept of home rule which I turn to in the concluding chapter.

As the above implies, we should not be blind to the lessons of our shared history, but we need to be aware that history moves on and that constitutional arrangements need to be aware of this and adapt accordingly. My own view is that in social, economic and cultural terms the Union has been a substantial success for most of our peoples and most of the time. Many Scots appear to wish for a continuation of the Union under the Crown and support the continuation of a "social union" with the free movement of people, capital and services within the UK. Yet, it is also true that the UK has become an increasingly centralised economy, in terms of the increased share of national income accounted for by central taxation and the increased intervention of central government in a wide range of social and other activities. Hence the Scottish Parliament, funded by a block grant and unable to borrow to finance major public infrastructure projects, does not have the policy instruments to make a major impact on economic performance. Yet, it was always the intention of home rule as understood in Scotland, that it "should set the people free" within a federal framework, so that they carried the main responsibility for their own social and economic welfare, subject to the constraint that they also had a duty to promote the welfare of the wider Union.

So let us take home rule as the construct, this going beyond "devolution max" but consistent with "independence lite". My purpose is to set out what this implies for economic policy. Taking John Major's starting point, I would have added one word - inserting 'macro' in front of 'management'. That is, a stable economic framework requires what the Eurozone called a 'Growth and Stability Pact'. We should understand, of course, that the Pact was constructed in a fashion that could be expected to produce less growth and less stability in the Eurozone and duly did! Our historical experience is that the UK has been a Union that did promote growth and stability over much of its history. The framework may, indeed, need major refurbishment, but it will only flourish if macroeconomic monetary and fiscal policy are applied in a manner which is transparent and reasonably consistent across the Union. It should be understood that reasonably consistent does not mean that all the microeconomic details should be the same. And, having regard to the fact that the word economics is derived from the Greek word 'oikonomikos' meaning household management, the successful resolution of microeconomic issues is the key to a successful economic policy.

CHAPTER 2
IS RECENT ECONOMIC HISTORY A HELP?

BY PROFESSOR JOHN KAY

Scotland has a population of 5.2m, 8.4% of the 62m population of the UK, though it is 32% of the size of the UK. More than half the population, however, lives in the central belt, in and around and between the two principal cities of Edinburgh and Glasgow. Although the memorable visual images of Scotland are of a majestic and largely uninhabited landscape, Scotland is a predominantly urban country. And a prosperous one.

MEASURING SCOTLAND'S ECONOMIC PERFORMANCE

The most commonly used international measure of economic performance is gross domestic product, GDP. National accounts for Scotland are not compiled, but the UK's Office for National Statistics makes estimates of Scotland's gross value added (GVA). Scottish GVA in 2009 was £103 billion, just under £20,000 per head of population *(Office for National Statistics)*. GVA differs from GDP only in that the value of output is measured at factor cost. It therefore excludes indirect taxes such as VAT.

The largest component of both GVA and GDP is earnings, followed by the operating profits of businesses. The allocation of the profits of a modern company with operations in many countries and a complex corporate structure to particular jurisdictions is increasingly difficult. This problem is particularly great for a small country, which may be the headquarters location of a large company most of whose activities take place outside Scotland (Royal Bank of Scotland) or host to a company for which Scotland is a small part of its overall operations even though these activities are a substantial part of the Scottish economy (BP).

What proportion of the reported profits (or losses) of Royal Bank of Scotland arise in Scotland? It is not easy to see how one would go about answering this question, and the company currently does not know (and is not asked). The company's corporation tax assessment might appear to provide a basis, but the treatment depends on whether international operations take place through branches or subsidiaries, and the corporate structures of groups such as RBS are extremely complex, partly for these reasons. Moreover, the corporation tax calculation relates to profit attributable to shareholders, not the operating profit which is relevant to GDP or GVA (for a bank or an oil company, these will be very different figures). Payment of corporation tax is the result of lengthy and complex negotiation, which owes as much to pragmatic bargaining as to economic principle.

An alternative measure of economic performance is gross national income (GNI). This concept does not include profits earned within the boundaries of Scotland (wherever the beneficial owner lives) but the property income derived by residents of Scotland (wherever the activity that produces the profits takes place). For a small country, this difference between GDP and GNI may be very large – for Ireland, GDP has recently exceeded GNI by around 20%. The success of Ireland in attracting inward investment, combined with a favourable corporation tax regime, encourages companies not just to earn profits in Ireland but also to attribute as much as possible of their global profits to Ireland. The result is that global companies with some operations in Ireland report profits earned in Ireland which are large relative to the size of the Irish economy, but from which Ireland derives little or no benefit, and which may in reality have little connection with Ireland. Although the 'Celtic tiger' phenomenon was real, the widespread reporting of figures for GDP growth, which includes such profits, led to exaggeration of its extent both internally and externally. The claim that *per capita* GDP in Ireland had come substantially to exceed UK and average European levels considerably overestimated the actual standard of living of the Irish population. No estimates are made of Scottish GNI.

These technical questions of data measurement and interpretation, and the limitations of available information are of considerable importance in understanding Scotland's economic performance and in interpreting Scottish economic statistics. This importance will emerge in discussion of major Scottish industries – oil, whisky, banking – and in the implications of the loss of corporate headquarters from Scotland. They are also relevant to the implications of a lower corporation tax rate for Scotland. If the Scottish economy looks in many respects similar to the UK economy as a whole, one reason may be that in the absence of other evidence the easiest way for statisticians to obtain a figure for Scotland is to take the corresponding figure for the UK and *pro rata* that figure to Scotland.

Given these caveats, it is foolish, although common, to attach much significance to small differences between Scotland and the UK, in levels or in trend. Nevertheless, even a faulty speedometer may often give an indication of whether you are driving faster, or slower, and changes in data are often a guide to developments in the real economy, even if there are problems within the data itself. Aggregate data should, however, constantly be reviewed against qualitative and even anecdotal experience of everyday events. The observations that follow should be read in the light of these reservations.

Since the Second World War, estimated GDP *per capita* in Scotland has been between 90% to 100% of GDP per capita in the UK. That figure dropped briefly below 90% in the mid 1960s, but tended to rise in the three decades that followed. By the mid 1990s, the difference appeared to have been more or less eliminated, but Scotland appeared to benefit less than the UK as a whole in the rapid expansion during the new economy boom of the second half of that decade. The characteristic small gap has re-established itself. Earnings data, drawn from largely independent sources, shows a similar picture.

Earnings and estimated GVA per head in London and the South East are much higher than those of the UK as a whole, so that Scotland is otherwise the UK's most prosperous region. Scotland is very different from the two other areas of the UK with substantial devolved powers – Wales and Northern Ireland. Wales is significantly poorer than Scotland or the UK, most of the Welsh population lives within fifty miles of the English border, and for that population transport links to England are often better than transport links within Wales itself. Northern Ireland has low per capita income and is substantially dependent on budgetary transfers from Westminster. Like England, Scotland has a capital whose conurbation is much the most prosperous part of the country. It is much easier to imagine Scotland as a standalone economic entity than is true of Wales or Northern Ireland.

The undoubted economic viability of an autonomous Scotland does not, of course, establish a political case for that outcome. Most of Scotland's trading relationships are with England. We do not have data on trade flows within the United Kingdom, but it is reasonable to suppose that for Scotland, as for other small Western European countries, imports to and exports from Scotland would make up well over half of national income - 70% is probably a realistic estimate – and most of that would be intra UK trade.

Scotland's recent economic performance may also be compared with other small European countries (See Professor David Simpson's chapter). This data also raises many issues of interpretation and measurement as well as economic substance. Ireland, Finland and Portugal have all, for historical political reasons, had scope to catch up with general European levels of productivity and standard of living: Ireland and Finland have indeed caught up, though Portugal has not. As noted above, GDP measurement overstates Ireland's economic performance. The same indicator understates the performance of Switzerland, partly for related reasons – while Ireland has GNP well below GDP, Swiss GNP is well above GDP, a result of both the global strengths of Swiss companies and foreign asset holdings of Swiss residents.. In addition, Switzerland has benefited from steady improvements to its terms of trade. The rising dollar prices of Swiss exports, a tribute to the competitive strength of Swiss business, is not recorded in GDP growth. Norway's figures are dominated by its high oil revenues, while Iceland's are made farcical by the boom and bust in its financial services sector. Still, balancing all these factors and making appropriate reservations, it is hard to assess Scotland's performance as other than mediocre by general European standards.

Although GDP *per capita* in Scotland has moved broadly in line with the UK average, GDP itself has grown more slowly, and so Scotland accounts for a declining share of total UK economic activity. The reason Scotland has a diminishing share of the UK population. In fact the population of Scotland has not risen much since the 1970s and has recently been in danger of falling in absolute terms.

Scotland has experienced significant emigration since the nineteenth century. The Highland Clearances and the depopulation of large areas of rural Scotland were reality, as well as legend. But pull and push were at work: Scots explored the opportunities available around the world to enterprising, educated young people, in the British Empire and the United States. In the mid 1990s, net migration fell to zero, for the first time for a century, and perhaps much longer. This coincided with the date at which Scottish GDP *per capita* matched that of the UK. House prices in Scotland are around two thirds of UK levels.

Scotland's population exceeded 5m for the first time in 1951, and has remained at about that level since. Although the total fertility rate has been slightly below the UK average, both Scotland and the UK have fertility rates close to replacement level (in line with France and the Scandinavian countries, but well above levels in Germany or South Europe. The stability of the population is the result of net emigration. In 2002, Scotland's population was expected to fall below 5m, to 4.8m by 2032.

But these fears were exaggerated and the latest projections suggest that the population will rise to 5.5m over the next forty years. The birth rate has risen, and migration trends have altered significantly. Most immigration into Scotland is from England, but the increase in immigration is mainly explained by the accession of Eastern European States to the EU in 2004. Non-white immigration into Scotland is, and continues to be, relatively much lower than for the UK as a whole.

The two main factors in the improvement in Scotland's relative position since the mid 1960s are the development of North Sea oil production and Scotland's success in attracting inward investment. The first major oil discovery was the Forties field, located in the North Sea, 110 miles (180km) east of Aberdeen, where oil was struck in 1970. The value of current output of this find alone represents around 2% of Scottish GDP.

Oil has a macroeconomic and microeconomic impact on Scotland's economy. The macroeconomic impact results from the import substitution crossing from the value of oil production, which raises the exchange rate, improves the terms of trade, and squeezes non-oil production of tradable goods and services. There is a fiscal effect because a substantial part of the economic rent attributable to oil production accrues to government through royalties and corporation tax.

Since Scotland is part of both a monetary union (the UK has a common currency) and a fiscal union (the UK has a common treasury), these macroeconomic effects arise at the level of the UK as a whole. The SNP was not slow to recognise that a division of oil output by geography would give very different results to a division by population share. Applying standard international bases of allocation might put 80% of North Sea output in the Scottish sector.

The microeconomic impact of oil production arises from the onshore service activities required. Pipelines land at Kinneil, Dalmeny and Hound Point, while Aberdeen is the principal air base for supplies of offshore rigs. The development of these service activities enabled Scottish businesses to acquire skills which could be employed not only in the North Sea but in oil exploration and development elsewhere in the world. The growth of oil output thus acted as a wider stimulus to the Scottish economy.

From the 1950s, the UK government adopted regional development policies aimed at encouraging investment in areas of the UK (including the west of Scotland and the Highlands) with incomes and activity levels significantly below the UK. Showpieces of these policies included a car assembly plant at Linwood in Renfrewshire, an aluminium smelter at Kinlochleven near Fort William and a steel mill at Ravenscraig in Lanarkshire. While these installations were the result of UK wide regional development policies, focussed promotional activities through the Scottish Development Agency enabled Scotland to be successful in the competition to attract inward investment, especially from US and Asian companies anxious to establish bases in the European Union.

Inward investment is, however, a fragile basis for sustained growth. Assembly plants and distribution centres attracted mainly by subsidies are, by their nature, footloose and vulnerable to marginal shifts in costs and economic conditions. Linwood and Ravenscraig were never viable sites. Electronics assembly in central Scotland – attracting these plants was regarded as a major success in the period to 1995 – contracted sharply after the technology bubble burst in 2000. This reversal of fortune is a significant element in the overall explanation of the early strength and recent weakness in Scotland's recent economic performance.

This vulnerability of economic activity attracted by FDI to global economic development can only be reduced if FDI is the basis for the development of indigenous capabilities at skills which create competitive advantages likely to survive shifts in costs and prices. Evidently this did not happen to any substantial degree in the electronics sector. ‘Silicon glen’ was in this sense fundamentally different from silicon valley. The development of domestic skills has been achieved more successfully in oil and gas and in life sciences.

Since 1978, the public expenditure framework for Scotland has been set by the Barnett formula, devised in anticipation of the implementation of devolution proposals which fell in the 1979 referendum. As a result of effective negotiation by successive Secretaries of State, and the focus on regional development and the growing pressure for independence or devolution, Scotland in the 1970s had levels of public expenditure, which were significantly in excess of equivalent levels in England, but probably not justifiable on the basis of needs assessment. The Barnett formula effectively froze this allocation, but at the same time provided that increases in expenditure would be determined pro rata to the Scottish (and Welsh) populations.

Although the 1979 devolution plan did not go ahead, the Barnett formula was, and continued to be used in the calculation of the block grant to the Scottish Government after the Parliament and Executive were created in 1999. In principle, the Barnett formula should imply long term convergence between *per capita* expenditure levels in Scotland and those of the UK as a whole. In practice, the outcome of negotiation over the block grant mean that such convergence has not occurred, and public expenditure in Scotland has remained 10% - 15% above its English equivalent.

The Scottish public expenditure position since 1980 may fairly be characterised as a tacit agreement in which questions about shares of oil revenue are not asked, or answered, in return for a settlement which treats Scotland generously. This convenient silence cannot continue in the event of independence, or any substantial increase in devolved power. It may not survive increased assertiveness on the part of the Scottish government and parliament, and the adverse English reaction to the anomalous position of Scotland within the UK legislature which must follow such increased assertiveness.

In consequence of this tacit constitutional agreement Scotland shared – but no more than shared – in the pressures on public spending, and especially on capital expenditure, in the Thatcher era and the decade that followed. The UK public expenditure position shifted substantially after 2000, and controls were substantially loosened. Increases in public expenditure in England were particularly focused on health and education – functions devolved to Holyrood under the 1997 Scotland Act. This led to substantial year on year increases in the block grant to the Scottish government. Between 2000 and 2006, allocations to Scotland rose by 42% in real terms.

The early years of devolution were years in which the Scottish government had more money to spend than was consistent with learning the habits of good budgetary discipline. One result can be seen in the proliferation of populist policies, such as free university places, prescriptions, the abolition of bridge tolls, and ill-conceived flagship projects such as the Edinburgh trams. The more substantial question is whether Scotland gets value from its relatively high levels of public spending. Scots take pride in their education system, at both school and university level, but that pride owes more to past achievement than current performance. Above UK average levels of health expenditure are accompanied by below UK average health outcomes.

In parts of Glasgow, mortality rates are at levels associated with third world countries rather than Western Europe. More generally, Scotland's economic performance is blighted by pockets of deprivation mostly in west-central Scotland. Put bluntly, Scotland has two successful cities – Edinburgh and Aberdeen – and two unsuccessful ones – Glasgow and Dundee. Glasgow has shown signs of revival, not only projecting a more attractive image but winning new job opportunities, and has some vibrant areas and suburbs. But the desolation of post-war housing estates remains a feature of Scotland's urban landscape, particularly in the West of Scotland. The same communities appear towards the bottom of the scale in any assessment of economic performance – activity levels, benefit receipts – and also in social indicators such as crime and mortality. Moreover, these problems persist although their extent has been recognised at least since the 1980s and remain despite a range of targeted interventions to address them.

In contrast, rural Scotland has performed relatively well. In particular, productivity and living standards in the Highlands and Islands (as measured by GVA per capita) have stabilised at between 70% and 80% of the Scottish average and even shown a slight relative increase. Population decline has also been arrested.

Glasgow and Dundee, industrial powerhouses at the start of the twentieth century, were victims of the decline of Scotland's traditional industries. Success for small countries in global markets results from the exploitation of competitive advantage on an international scale, usually based on a limited range of activities. The development of the Scottish economy in the two centuries after the Union was partly the result of the ability of individual Scots and Scots businesses to provide the trading infrastructure for the British Empire. These activities included the achievements of the 'tobacco lords' and others who made Glasgow a great port: at the same time, Scots played a major role in both the exploitation and development of India, and became major providers of financial services, both from Edinburgh and in bases overseas such as Hong Kong. In the late nineteenth century, this position was reinforced by the establishment of competitive advantages in transport engineering, which made the west of

Scotland a global leader in the production of ships and locomotives.

The financial services sector adapted successfully to changing markets in the twentieth century; the heavy industrial sector did not. Success in attracting inward investment in the electronics sector in the 1980s gave rise to brief optimism that this would be an industry in which Scotland could develop a new competitive advantage: but, as became starkly apparent in 2000-2, the skill base employed was at too low a level for this to be a reality.

A similar hope today lies in life sciences, where several multinational businesses have established facilities in Scotland, along with some indigenous spin-off companies. There are perhaps better grounds for optimism. The reputation of Scottish medical schools has been recognised for centuries, but has never been developed into an industrial sector that would generate broader employment and revenues.

Support services for oil and gas developed in Scotland in line with the growth of oil output. The continuing evolution of production technology implies repeated extension of the life of fields, and although peak output is in the past significant production seems likely to continue more or less indefinitely. As noted earlier, Scottish firms such as Wood Group have developed capabilities which can be sold globally regardless of oil and gas output levels in Scotland itself.

There is current discussion of the prospects for a new renewable energy sector in Scotland. Scotland is wet and windy, and is currently the location of most of the UK's hydro-electric capacity. Scotland has coal fired generating capacity, a large gas powered plant at Peterhead, and two of Britain's seven AGR nuclear reactors (a legacy of the SSEB's management of the construction of such plants, which was more effective than that of the CEGB which exercised these responsibilities in England and Wales).

Approvals have been given for substantial new wind generating capacity. Wind and rain are not, however, a new North Sea. Offshore oil production is very profitable, and therefore not only yields returns for investors but substantial government revenues. The generation of electricity from wind is not profitable, and its economic viability is dependent on either direct taxpayer subsidy or its substitution for other lower cost electricity production. Locations which are windy and avoid disturbance to local residents tend to be remote, and the costs of transmitting the power which is generated to the south of England, where UK electricity demand is concentrated, are substantial. The financing of these developments is therefore dependent on the willingness of English electricity consumers or taxpayers to provide subsidy for both renewables production and the transmission of the power it provides from remote locations.

Recent UK government policy, reinforced in the recent UK energy white paper suggests that such willingness may be forthcoming. If so, then Scotland can attract a disproportionate share of such plant, and may – as it has in oil and gas – be able to develop supporting service activities.

The visual attractions of Scotland are turned to economic benefit in its tourism, food and drink industries. Scotland attracts around 6m visitors per year from England and 2.5m from other countries; total expenditure (including intra-Scotland trips) is estimated at £4bn and resulting employment 200,000. Given Scotland's tourist potential, this is not an impressive figure: the UK receives 28m international visitors per year and international visitors to Norway and Sweden are twice, and Ireland three times, the Scottish level.

Scotland is a producer of premium food products – meat, fish and certain fruits. This is essentially an export market – the Scottish diet is notoriously unhealthy, and so long as this remains true it is difficult to establish an identifiable Scottish brand in this sector. The iconic Scottish product, however, is whisky.

A merger of the vast majority of Scottish whisky producers in the 1920s created the Distillers Company. For more than half a century the company epitomised weak management: the overall market declined and with that the Distillers Company share was steadily eroded. The company's attempts at diversification mostly failed and included a disastrous foray into pharmaceuticals in which Distillers became UK licensee for the drug thalidomide, eventually withdrawn after evidence of birth defects resulting from its use by pregnant women. Finally, in 1986 the company was bought by Guinness which outbid a Scottish based acquirer in a controversial takeover contest.

Guinness significantly improved performance; The business was rationalised: demand for whisky was stabilised and has, since the mid 1990s, been increasing. But much of the growth has come from other producers outside the Distillers group. The second largest producer of Scotch whisky is now the French based drinks conglomerate, Pernod-Ricard (France is, to most people's surprise, the largest export market for Scotch whisky). Other major players include the Miami-based Bacardi and the Indian based United Distillers. There are substantial growth prospects for Scotch whisky in developing country markets, especially India, where consumption of low quality indigenous brown spirits is a legacy of the British raj. There are two significant Scottish based producers – the Edrington Group (wholly owned by a charitable foundation, the Robertson Trust) and the privately held Wm Grant.

Thus ownership of the whisky industry mainly lies outside Scotland and this illustrates sharply the significance of the difference between GVA or GDP and GNI. Value added from Scotch whisky is reported as around £3bn – about 2½% of Scottish GDP – but this figure reflects essentially arbitrary transfer prices and export valuations. Around 10,000 people are employed in the Scotch whisky industry: their wages and salaries, and purchases of goods and services used in whisky production amount to only about £400m. To this should be added the returns to beneficial Scottish ownership of whisky related assets.

With retail sales of whisky around the world totally perhaps £25bn, the Scottish economy appears to derive modest benefit from its most famous product.

In the course of the Guinness bid for Distillers in 1986 assurances were given that a Scottish chairman would be appointed for the whole business, whose head office would be located in Edinburgh. These assurances were immediately reneged on when the takeover was completed. This admittedly extreme example illustrates a general problem of erosion of corporate headquarters functions from Scotland.

UK policy in the last two decades has favoured this trend. In 1981, two competing bids for Royal Bank of Scotland were rejected by the Monopolies and Mergers Commission, which feared damage to the Scottish economy from the loss of a headquarters activity in Edinburgh. Five years later the Guinness bid was not referred to the Commission following commitments by Guinness to dispose of some of its smaller whisky brands. The 'Tebbit guidelines', promulgated by the UK Secretary of State for Trade and Industry in 1984, had excluded the issue of headquarters location as grounds for reference to the MMC. The contrasting results can be seen today on the journey from Edinburgh Airport to the city centre, which passes both the global corporate headquarters of RBS and the shuttered former Scottish offices of Distillers.

Headquarters activities have steadily disappeared from Scotland. Among Scotland's leading whisky producers, Diageo's head office is in London, Pernod-Ricard's in Paris, Bacardi's in Miami and United Distillers in Mumbai. Scottish and Newcastle Breweries became Scottish Courage and was acquired by Carlsberg (Copenhagen). Scotland's largest food group, Grampian Foods, is owned by a Dutch cooperative, Vion (Eindhoven). In financial services, General Accident became part of Aviva (London), Scottish Equitable was bought by Aon (Chicago), Scottish Amicable by Axa (Paris), and Scottish Widows by Lloyds (London), though Scotland's largest life insurer, Standard Life, remains Edinburgh based. In 1980, electricity in Scotland was produced by the South of Scotland Electricity Board and the North of Scotland Hydro-Electric Board. Privatisation and a subsequent takeover led to the absorption of the former SSEB into Iberdrola (Bilbao). Scotland's nuclear capability is owned by Eléctricité de France (Paris). The former Hydro Board is now part of Scottish and Southern Energy (Perth, Scotland).

Some recently established Scottish companies have developed into international businesses. Two large transport companies, First Group (Aberdeen) and Stagecoach (Perth), exploited opportunities created by the privatisation of bus and rail services. Wood Group (Aberdeen) exploited successfully the development of oil services, and Clyde Blowers (Glasgow) has become a substantial engineering group through the acquisition of the pumps division of the Weir Group, which was however, sold in 2011 to SPX (Charlotte, North Carolina). Weir itself, once the global leader in the production of steamship engines, is almost the only company from Scotland's industrial history to have successfully reinvented and revived itself.

Scotland's leading business figures today are, to a striking degree, self-made entrepreneurs: men such as Brian Souter (founder, with his sister Ann Gloag, of Stagecoach), Jim McColl (Clyde Blowers), Ian Wood (Wood Group), Tom Hunter (retailing), Tom Farmer (Car repair). There are, however, many Scots in senior positions in large multinational companies outside Scotland.

Royal Bank of Scotland, its independence secured by the MMC, was revived and in 2001 acquired the much larger National Westminster Bank, against competition from rival Bank of Scotland. RBS was successful in reducing the NatWest bureaucracy (a task that had eluded previous generations of NatWest managers), earning the title of 'Fred the Shred' for its soon to be notorious chief executive, Fred Goodwin. But hubris ensued: the bank grew its balance sheet too rapidly and engaged in further international and business diversification, culminating in the disastrous purchase of ABM-AMRO in 2007 as the credit crunch began to bite.

Bank of Scotland merged with Halifax in 2002 to form HBOS, with Halifax the dominant partner in the combined concern. HBOS also expanded its corporate lending and wholesale market activities. In October 2008, both banks faced collapse. RBS was rescued by the UK government, which engineered a rescue bid for HBOS by Lloyds.

The taxpayer became the majority shareholder in both RBS and the combined Lloyds/HBOS group. Scotland's two largest companies (at its peak, RBS employed 170,000 people around the world, and reported £15bn – more than 10% of Scottish GDP – in annual profits) had been humiliated. The reputation for providence of Scottish financial services, an important source of national competitive advantage, had been severely tarnished.

Fortunately, the reputation of Scottish financial services is not dependent on banking alone. The two other main sectors of the financial services industry in Scotland are asset management and insurance. Scottish asset managers had been relatively conservative in the decade before the credit crunch, largely eschewing the booming sectors of private equity and hedge funds: a conservatism which served them well when boom turned to bust. Insurance (principally life insurance) remains relatively strong, though somewhat focussed on business models – endowment policies and intermediary distribution – that are in decline. The Lloyds Banking Group has committed to maintaining the head office of the insurance activities of the combined group in Scotland, although experience, most of all with Guinness and Distillers, suggests that such commitments are never binding and cannot be relied on in the long term.

Scotland's economic performance since 1980 has been neither especially good nor especially bad, whether judged by reference to the UK as a whole or relative to the performance of other small European states. There is nothing in recent Scottish economic history, or its current economic position, to indicate that Scotland would not be viable as an independent state, certainly as part of a customs union (the EU) and probably as part of a monetary union (either the UK or Eurozone). The public expenditure settlement would obviously be a central part of any discussion of further devolution or independence, and the relationship of banks to the state in which they are headquartered is also an issue for Scotland though one which could be more appropriately resolved in a global economic forum.

Scotland has actual or potential competitive advantages in a number of sectors, especially oil and gas services and financial services, although the latter has suffered a severe blow in 2007-8. Food and drink, and tourism, all have real competitive advantages, but fall short of the potential they offer the Scottish economy. Life sciences is a hopeful prospect. There have been a number of impressive success stories in recent Scottish business history, but the most important overall phenomenon is the loss of headquarters functions from Scotland. The pull of London for both individuals and businesses would remain strong whatever Scotland's constitutional status, but Scotland has suffered from a conscious UK decision to allow an exceptionally free market in corporate control. Greater devolution of powers would give Scotland more ability to address this issue, which has significant implications for the nature and extent of entrepreneurship within Scotland, which is in turn one of the most important determinants of Scotland's growth prospects.

Levels of public expenditure in Scotland are generally above equivalent UK levels, although they are not particularly high by European standards. It is far from clear that Scotland gets value for money from what is spent. Infrastructure spending in Scotland has been too low for too long. There has been some improvement in the state of the capital stock in health and education – much of it expensively purchased through PFI and other off-balance sheet transactions. But transport spending has been inadequate and wastefully directed and the state of social housing is dire.

Scottish housing was substantially worse than that of the UK as a whole at the beginning of the last century, even when Scotland's relative income position was favourable. The situation today is an unfortunate legacy of well-intentioned but substantially misdirected redevelopment in the 1950s and 1960s, which has now been translated into some of the most serious pockets of urban deprivation in Europe. Scotland is a victim of institutionalised community failure which was created within Scotland and which has proved resilient even in the face of determined attempts to overcome it.

The list of problems is long, as is the list of opportunities. It would be a mistake to devote too much time to a debate on the framework of governance for Scotland relative to the issues which any such framework of governance would be required to tackle.

CHAPTER 3
AN ENVIRONMENT FOR ECONOMIC GROWTH: IS SMALL STILL BEAUTIFUL?

BY PROFESSOR DAVID SIMPSON

1. INTRODUCTION

Thirty years ago it was not difficult to believe that small was beautiful, at least in the economic sense. The small countries of North Western Europe were at that time growing steadily. They provided standards of living for their citizens higher than most of their larger European neighbours, standards of living that Scotland could only envy. But recent events have raised doubts in many minds as to whether this is still true. Are small European countries still as prosperous relative to their larger neighbours as they used to be? Are they perhaps growing more slowly? Are they more vulnerable to cyclical downturns? Is small still beautiful?

In this paper I first look at the evidence. International comparisons appear to confirm the supposition that, in general, small European countries continue to prosper both relatively and absolutely. Then I examine in particular the recent experience of Ireland.

When something is seen to be working in practice, academic economists will worry whether it works in theory. So the third section of the paper discusses some of the theories that have been advanced to explain the influence of size of country on economic performance. In section four I suggest that the ability to design appropriate economic policies together with a culture of confidence provide a positive environment for economic growth. I conclude that while size doesn't matter, perhaps sovereignty does.

2. THE ECONOMIC CONSEQUENCES OF THE SIZE OF NATIONS: THE EVIDENCE.

2A. INTERNATIONAL COMPARISONS

Table 1 shows some recent data for eighteen countries of Western Europe. Their economies may be thought to be comparable in the sense that they have been subject to similar influences of consumer behaviour, technology, and business and political culture. These countries are ranked in decreasing order of income per head (GDP per capita) in Column (1) of Table 1. The population of each country is shown in Column (3). Casual inspection suggests that size of country and standard of living may be inversely related. In other words, smaller Western European countries are in general better-off than larger ones. This impression is confirmed by a rank correlation coefficient (Spearman's rho) between columns (2) and (4) of -0.6037, (t= - 3.03).

TABLE 1: WESTERN EUROPEAN COMPARISONS OF GDP

Country	GDP per capita (1)		Population (2)		GDP 1990-2006 (3)		GDP 2008-2009 (4)	
	$000	*Rank*	*Million*	*Rank*	*% change*	*Rank*	*% change*	*Rank*
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Luxembourg	78.4	1	0.5	17	79	2	-4.1	10
Norway	52	2	4.7	15	65	3	-1.4	18
Switzerland	40.5	3	7.3	12	20	18	-1.9	17
Netherlands	39.9	4	16.4	6	39.3	10	-3.9	12
Ireland	38.7	5	4.2	16	110.9	1	-11.4	1
Austria	38.6	6	8.2	11	37.6	11	-3.8	13
Iceland	37.9	7	0.3	18	53	5	-9.8	2
Sweden	35.9	8	9.4	10	34.7	13	-5.5	7
Denmark	35.8	9	5.4	13	33.8	14	-5.6	6
Belgium	35.5	10	10.4	9	35	12	-2.7	14
United Kingdom	34.4	11	61.1	3	39.8	9	-4.9	8
Germany	34.4	12	82.2	1	30	16	-4.7	9
Finland	33.4	13	5.3	14	40	8	-8	3
France	33.4	14	65.1	2	31.8	15	-2.5	16
Greece	29.8	15	11.1	7	55	4	-5.9	5
Spain	29.6	16	46.7	5	50	6	-4	11
Italy	29.1	17	59.3	4	25	17	-6.3	4
Portugal	22.7	18	10.7	8	42.8	7	-2.6	15

DEFINITIONS AND SOURCES

(1): GDP per capita at purchasing power parity 2009, IMF World Economic Outlook Database October 2010
(2): Population, Wikipedia List of Sovereign States in Europe by Population, most recent available data
(3): Real GDP, percentage change 1990-2006, IMF World Economic Outlook Database October 2010
(4): Real GDP, percentage change 2008-2009, IMF World Economic Outlook Database October 2010

The fifth column of Table 1 shows a measure of medium term growth, cumulative GDP growth rates for the countries of Western Europe over the period between 1990 and 2006. The corresponding ranking of performance is shown in column (6). Again, there appears to be an inverse relationship between size of country and rate of economic growth, and this is confirmed by a rank correlation coefficient between Columns (4) and (6) of – 0.5273, (t = - 2.48).

Turning to vulnerability to downturns, Column (7) measures the cumulative fall in GDP experienced by each of the countries in the recent recession.[1] Comparing the rankings of columns (4) and (8) suggests that smaller countries appear to have fallen further than larger ones. However, the correlation is not statistically significant. The coefficient has a value of -0.2198, while t = -0.9.

2B. THE IRISH EXPERIENCE

It is worth looking more closely at the particular experience of Ireland, because of the comparability of many of its circumstances to those of Scotland. Ireland has enjoyed a remarkable record of medium term economic growth, as well as an equally remarkable boom and bust between 2005 and 2010. Table 1 gives the numbers. After a spell of 16 years during which the Irish economy grew at an average annual rate of almost 7% in real terms, output declined by more than 11% between 2007 and 2010.

There is no mystery as to why this happened, no real dispute as to who is to blame for the recession in Ireland.[2] The politicians and regulators who were responsible have not been allowed to hide behind the smokescreen of a 'global financial crisis' and 'greedy bankers' laid down by their UK counterparts.[3] The rapid rise and subsequent collapse of real output in Ireland over the last five years was a home-grown phenomenon that exhibited the classic pattern of boom and bust. A domestic speculative boom, in this case in housing, was inevitably followed by an equally spectacular collapse of the banks that had so recklessly financed the boom. When house prices began to reach levels exceeding those of comparable houses in London, then even the dogs in the streets, as they say in Dublin, could see there was a boom in progress that could only have one outcome, a financial crisis. This in turn

1 Looking at annual data, half of the countries in our sample experienced a fall in GDP only in the year 2009. However, Denmark, Sweden, Portugal, Italy and the UK declined both in 2008 and in 2009. GDP in Iceland, Spain and Greece fell in 2009 and 2010, while Ireland's fall was spread over three years: 2008, 2009 and 2010. The data in Column (7) represent the cumulative decline in each country in whatever years it took place.

2 *See The Irish Banking Crisis: Regulatory and Financial Stability Policy 2003-2008.* Report to the Minister for Finance by the Governor of the Central Bank, Dublin, 31 May 2010.

3 It is mildly astonishing to see how successful this smokescreen has been. Adair Turner has been almost alone in confessing that "We need to…recognise that, in finance and economics, ill-designed policy is a more powerful force for harm than individual greed or error". *The Daily Telegraph* 22.9.10.

precipitated a fall in real national output, a fall that was exacerbated by the unwise decision of the Government in September 2008 to guarantee all of the banks' debts. Sovereignty, unfortunately, does not confer immunity from errors of judgment.[4]

This is not the first time that the Irish economy has stumbled – from 1974 to 1975 GDP fell by over 5%. It fell again in 1983, and it is likely that there will be other recessions in the future, although we cannot say when. But intermittent periods of boom and bust have not altered the fundamental factors driving the long run growth of the Irish economy. This growth path is neither a 'miracle' nor an accident. It is, for once, the result of a consciously designed economic policy, one that was adopted as long ago as 1958[5], and which has been steadfastly pursued for more than half a century. That policy is the establishment in Ireland of exporting industries through the attraction of foreign direct investment. The main elements of the policy have remained unchanged: access to foreign markets, a supply of young and talented people, use of the English language and a low rate of corporation tax. As time has passed, success has been self-reinforcing: the policy's track record has become an additional attractant. As a result, foreign direct investment has remained largely unaffected by cyclical downturns. In 2010, a year of recession in Ireland, the flow of foreign direct investments exceeded that in 2004. Of the 125 new foreign investments in 2010, 43 are companies that are new to the country[6].

3. ECONOMIC CONSEQUENCES OF THE SIZE OF NATIONS: THEORIES

3A. SIZE OF MARKET

Adam Smith emphasised the necessity of small states having access to wider markets if their economies were to grow. Guaranteed access to the larger English market had been one of the main arguments in favour of Scotland's Treaty of Union with England in 1707. But when Mrs Thatcher signed the Single European Act in 1987, she rendered superfluous the corresponding provisions of the Treaty of Union.

In the contemporary world of possibly increasing protectionist tendencies, there are advantages in belonging to a trade bloc with significant negotiating power like the EU. So far as monetary arrangements are concerned, these are discussed by Professor Hughes Hallett in Chapter 8. Here, it may be sufficient to say that the advantages of belonging to a

4 A principle also illustrated by some episodes of UK economic policy-making. See, for example, Hennessy (1996), p. 14.

5 See T.K Whittaker, *A Programme for Economic Development*, Department of Finance, Dublin 1958.

6 *The Guardian*, 7 January 2011

larger monetary union are less obvious. For example, Ireland's membership of the eurozone has made its adjustment to changing circumstances more difficult, whereas countries like Norway and Switzerland have had fewer such problems.

3B. COSTS OF SUPPLYING PUBLIC SERVICES

There is a school of thought[7] that believes that amongst modern states, the nature of sovereignty has altered profoundly. It is suggested that what European citizens really want nowadays are efficiently delivered public services, and that the organisational level at which public services are best delivered is determined by economic considerations, notably by the existence of economies of scale. So, for example, it is said that rubbish collection and primary education might be organised at a local level, police, fire and health services at a regional level, monetary and foreign policies at a national level, and trade and environmental policies at a supra-national level.

Listing these activities and their supposed level of lowest cost of delivery, however, is sufficient to illustrate the opposite argument, namely that the preferred level of delivery of public services is normally a matter of political rather than of economic choice. When some powers of government were devolved to Scotland in 1999, they included responsibility for health, education, police, fire and environmental services. This happened not because Scotland was thought to be an optimum size of unit for the delivery of these services, but because it was thought that Scotland should have the option to pursue different policies concerning the organisation and delivery of public services if it chose to do so[8]. Likewise, whether the UK should adopt the euro as its currency or continue to operate its own monetary policy is not so much a question of whether the eurozone approximates an optimal currency area as a matter of political preference on the part of UK voters.

Sovereignty resides in the option to exercise those choices. In other words, a sovereign country is one that has the right to decide at which level it wants each of its public services to be delivered. Sovereignty may no longer be indicated by the existence of embassies, national armies, national airlines or steel industries, it remains nonetheless as important to a country as it always has been. In the contemporary world of trans-national negotiation and agreement, sovereignty means a seat at the table.[9]

There is one important public service that does not appear in the

7 See, for example, Bobbit (2003), Cooper (2003) and Kay (2009).

8 For example, if the rather simple function of regulating the water industry were transferred to the UK regulator in Birmingham, Scottish water users would avoid the cost of maintaining a separate regulator here. But successive Scottish governments have wished to pursue different policies towards the supply of water from those prevailing in England & Wales.

9 Cooper (2003), p.44

foregoing list. Defence perhaps comes closer than any other service to the economist's definition of a pure public good[10]. If I am protected by the provision of a defence service, then my neighbour can be protected at the same time at no additional cost.[11] If defence is indeed a public good, then the average per capita cost of supplying a given level of defence service must be higher in smaller states than in larger ones. Furthermore, the continuously increasing sophistication of defence technology means that the costs of provision of a given level of protection have been moving relentlessly upwards. Today even large nations like the UK have difficulty in meeting these costs.[12]

Therefore if the organisation of defence provision were to be decided on purely economic grounds, then it might be efficient for a small sovereign state like Scotland to contract with a larger state, say the United States, to provide it with defence services. It is unlikely, however, that any such contract could be negotiated without political strings being attached. It seems more likely, therefore, that a small sovereign state will make its decision about the organisation and delivery of its defence services on political grounds, even if that should cost it more.

3C. ARE SMALL STATES MORE VULNERABLE THAN LARGER ONES TO FINANCIAL CRISES AND ECONOMIC DOWNTURNS?

The argument in Scotland is usually put more specifically. It is claimed that the tax base of an independent Scotland would have been too small for the Government of the country to have been able to bail out its banking system in October 2008 in the way that the UK Government did.[13]

Had Scotland become independent before October 2008, it is impossible to know the precise circumstances its Government would have faced at that time. Would it have permitted a takeover of Bank of Scotland by the Halifax? Would the flawed regime of banking regulation that it would have inherited from the preceding UK Government still have been in place, or would it have had time to replace it with something more effective,

10 Consumption by one person of a public good should not diminish its availability for consumption by another. It should also be impossible to exclude potential users.

11 Except of course to the neighbour herself, if the existence of the service should incur an unwanted risk of retaliation.

12 The most recent Defence Review provided for the building of two new aircraft carriers, but not for the aircraft to fly off them.

13 It was suggested by the Brown Government that Scotland should be grateful to it for having provided RBS and HBOS with capital and debt guarantees. This is rather like a driver responsible for a major road accident seeking credit for taking the survivors to hospital.

such as that which prevailed in Canada[14]? Let us suppose, for the sake of argument, that it had kept the UK legislation and let us suppose further that the Scottish regulatory agency responsible for banking supervision had allowed the management of RBS and HBOS to behave as they did. In these circumstances, an independent Scottish Government would have had no choice but to organise an orderly liquidation of the two banks[15]. Assuming that the banks concerned were indeed insolvent, this would have been the right thing to have done.

It is now widely accepted[16] that if there is to be stability in a financial system insolvent banks must be allowed to fail. One of the factors contributing to the banking crisis of 2007-8 was the longstanding belief on the part of the management of the larger universal banks on both sides of the Atlantic that their organisations were so big that governments would never allow them to fail. This belief, which proved to be correct, made it quite rational for them to take the most reckless gambles, decisions that were facilitated by the willingness of the Fed, and to a lesser extent the Bank of England, to make available abundant supplies of cheap credit.[17]

For an orderly liquidation to be successful, governments must ensure that the inter-bank payments mechanism is undisturbed and that small depositors are protected: their claims must come before those of creditors. In the USA, procedures for dealing with the insolvency of retail banks, or resolution regimes as they are known, have been in place for some time. In the UK, the Government-sponsored Independent Commission on Banking is considering a similar scheme, albeit with a curious lack of urgency. When the banking crisis began in Europe in August 2007, no legislative arrangements seem to have been in place to permit the orderly liquidation of insolvent retail banks, so some governments guaranteed the debts of all their retail banks, providing them with taxpayer-funded capital, whether they wanted

14 The Canadian experience is instructive, both because of the similarities of the relative sizes of Canada and the US and of Scotland and England, and because of the strong Scottish cultural influences in Canadian banking and its regulation. No big Canadian banks failed during the recent recession.

15 Just such a scenario is spelled out in John Kay (2010).

16 Stephen Hester and George Matthewson of RBS, Bob Diamond of Barclays, and Jamie Dimon of J.P. Morgan have all made recent public statements assenting to this principle.

17 As Chuck Prince, then CEO of Citigroup, famously said three weeks before the financial crisis broke: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing you've got to get up and dance. We're still dancing". Quoted in The Guardian, 16.2.09.

it or not.[18] In those countries where banking debts were large relative to the size of the country's tax base, the effect of this government action was to turn a banking crisis into a sovereign debt crisis.[19]

Banks in countries like Iceland and Ireland had been able to run up large liabilities, because their creditors and depositors anticipated that their Governments would always bail them out in time of need.[20] Once Governments make it clear that in future insolvent banks will be allowed to fail, then the size of a country in relation to the liabilities of its banking system should no longer be a problem.

3D. ADVANTAGES OF SMALL SIZE

As environments favourable to economic growth, small countries have three practical advantages. There is first of all the advantage of homogeneity of preferences identified by Alesina and Spolaore[21]. A related advantage is that of adaptability. It is difficult to overestimate the importance of adaptability in the contemporary world of continuously changing tastes, technologies and trading conditions. It is generally believed that it is easier to turn around a small organisation than a large one, (metaphors about supertankers and teaching elephants to dance spring to mind). In the same way it may be easier for a small, relatively homogeneous society to adapt to changing circumstances.

When you are a small country that is a member of a supra-national organisation, you can often get away with policies that you might not be able to do if you were larger. For example, Ireland's low rate of corporation tax may be an irritant to some of its EU partners, but it is not a threat to them because Ireland is relatively small. Likewise, guaranteeing the debts of the Greek, Irish or Portuguese governments is not too heavy a financial burden for other European states, (indeed, the terms offer them a healthy rate of

18 Had some banks been allowed to become insolvent, funds would have migrated to the better managed banks. Alternatively, the Government could have used taxpayer funds to set up a new 'clean' bank that would, for that reason, have had no difficulty in attracting private capital and in making loans to viable businesses.

19 Most of the European states that have experienced a sovereign debt crisis (i.e. failing to persuade financial institutions to buy their government debt at tolerable rates of interest) are in the eurozone. This has led some media commentators to talk of a ' euro crisis '. It is no more a crisis of the euro than could an inability of New York City to meet its obligations to its creditors be termed a 'dollar crisis '. New York City becoming insolvent, which has happened more than once, has had and would have no effect on the dollar. Likewise, the bankruptcy of some member state governments could have no effect on the value of the euro unless the European Central Bank were to break its own rules and monetise the debt of these governments.

20 In the case of Iceland this required a certain amount of credulity on the part of lenders and depositors, perhaps encouraged by the rates of interest on offer.

21 Alesina and Spolaore 2003 p.226.

return). Coming to the financial assistance of the governments of larger countries like Spain or Italy, however, would be quite a different proposition.

4. SIZE DOESN'T MATTER: CONFIDENCE DOES

Given the large number of small European countries which are prosperous then size cannot be a barrier to prosperity. Indeed, the evidence of Table 1 suggests that the opposite may be the case.

What seems to matter for economic growth is not size, but confidence. An important connection between sovereignty and growth is the creation of a culture of confidence. A culture of confidence encourages business investment, whether indigenous or foreign. A culture of dependence, on the other hand, undermines self-esteem and hence investor confidence.

Economists of almost all political persuasions, from Marxists to monetarists, agree that the main driver of a market economy, the proximate determinant of its rate of growth, is the amount and quality of its private sector investment. As Keynes emphasised in his *General Theory*, the principal determinant of the level of private investment in a market economy is not the rate of interest, nor even the level of aggregate demand, but the state of confidence.[22] It is the state of confidence that is perhaps the most important link between sovereignty and growth.

Scotland enjoys many of the elements believed to be conducive to economic growth. It has the necessary physical and administrative infrastructure and a talented and hard-working population. What it lacks is a culture of confidence.

Our low level of confidence is not simply the result of recent events. It is deep-rooted and longstanding. It may in large part be the cumulative effect of three major episodes in Scottish history which, taken together, have had a catastrophic effect on national self-confidence, self-esteem and morale. These episodes were the Reformation of 1560, the Acts of Union of 1603 and 1707 and the Industrial Revolution of the nineteenth century.

The first of these was the outcome of a genuinely popular movement that put an end to a scandalously corrupt and self-serving ecclesiastical administration. However, one of its long run effects was to place a burden of responsibility on the individual that was perhaps too heavy for some to bear, thereby instilling feelings of personal inadequacy.

The Union of the Crowns in 1603 left Scotland bereft of political leadership – a vacuum existed where leadership should have been. Indeed, the absentee political leadership actively conspired to hamper Scottish economic development, as the history of the Darien Scheme reveals. The

22 J.M. Keynes, (1936) pp. 148-164. These pages appear to have been overlooked by many of those who like to call themselves 'Keynesians'.

Union of the Parliaments that took place a century later simply aggravated the situation, terminating any prospect that the functions of Parliament might one day evolve to fill the vacuum created by the absence of a Head of State. The Industrial Revolution, while in the long run materially advantageous to everyone, left a legacy of social dislocation and social segregation that reinforced feelings of inadequacy. This is not to deny that each of these historical episodes have had their beneficial consequences. It is simply to say that the adverse consequences, although less visible, have been profound.

Nevertheless, one hundred years ago many indigenous Scottish industries were prospering and some, like shipbuilding and marine engineering, could and did compete with any in the world. When these industries went into decline after the First World War there was a calamitous loss of business confidence, particularly in the west of Scotland, which has never really been recovered. Instead, since the Second World War there has grown up in Scotland a culture of dependence fostered, perhaps unwittingly, by government.

Successive administrations in Scotland since the War pursued a policy of seeking handouts from the UK Treasury, in other words, the policy of the begging bowl. Not surprisingly, this further undermined self-esteem and hence investor confidence. It was the opposite of a policy of self-sustaining economic growth based on sovereignty. There was never any coherent view of the long term objectives of economic progress and how these might be achieved. Rather, whenever anything urgent was deemed to be needed, jobs to be 'saved' or votes to be won, Whitehall was approached for favours, cap in hand. The political reputation of Secretaries of State for Scotland of both parties largely depended on how much money they could squeeze out of the Treasury. Industrial plants were distributed by decree or by open or disguised subsidy without any regard to their appropriateness or their prospects for long term survival. Thus aluminium smelters, strip mills, car factories and electronics plants came and went. Inward investment, too, was attracted indiscriminately. As soon as the subsidies disappeared, so did the jobs.

A culture of dependence is wholly antithetical to confidence and thus to growth. "Aren't we too small to be independent?", "Can we really afford it?" are not questions that are heard in other countries. The fact that they are asked repeatedly in Scotland is simply a reflection of our own low state of confidence.

One of the consequences of a culture of dependence, a society with a low level of self-confidence, is an economy that has been unable to adapt itself sufficiently rapidly to meet the need for change. This has meant large gross emigration that has gone on for more than a century. Those who emigrated have been generally more adventurous, more adaptable and more highly skilled than those who remained. The outcome is a pool of talent that is now quite shallow[23]. Many people, especially unionists, have despaired of this situation and believe that it can't be changed.

In fact, there is some evidence to suggest that it is not necessary to have a ready supply of native-born entrepreneurs in order to achieve economic growth, although that helps. It is having the 'right' business environment that counts. If the environment is sufficiently attractive, entrepreneurs will come. In an early example of development policy, King David I (1124-1153) attracted Norman barons to Scotland with grants of land because he believed they would help to modernise the country. Amsterdam in the 17th century, London in the 19th century, and California in the late 20th century have all been successful, not so much because of their native talent but because they attracted the 'right' people. One third of successful start-ups in California between 1980 and 2000 had Indian-born or Chinese-born founders[24]. If you create a sympathetic environment, the entrepreneurs will come. This, too, has been the lesson of Ireland.

A SUMMING-UP

International comparisons suggest that small size is not a handicap to economic growth: on the contrary, it seems to be an advantage. And, as Alesina and Spolaore remind us, the balance is tilting increasingly in favour of small countries as the world economy becomes more integrated. They point out that

"…as trade becomes more liberalised, small regions are able to seek independence at lower cost. A consequence is that the phenomenon of economic integration is intricately connected with political separatism."[25]

A particular lesson that Scotland can learn from the experience of small Western European states is that sovereignty brings with it two essential ingredients for economic growth: a culture of confidence and the ability to design policies to suit the country's own circumstances. The prosperity that these states enjoy today confirms that small is still beautiful.

23 As measured, for example, by the number of FRSs or by sporting achievements.

24 Ridley(2010) p. 259

25 Alesina and Spolaore (2003) p. 219

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CHAPTER 4
GERS: WHERE NOW?

BY JIM AND MARGARET CUTHBERT

INTRODUCTION

The publication of "Government Expenditure and Revenue in Scotland" – universally known as GERS – is one of the high, or low, points each year in the ongoing debate about the economic and political future of Scotland. In this chapter, we will argue that the annual GERS debate is essentially a sterile exercise. We will then try to answer the question "where should GERS go now?" We suggest a constructive way ahead – namely extending GERS into the type of accounts which a developed economy might expect to have. This would transform the annual debate into something much more meaningful.

But first, we examine how GERS started, and how it has developed.

GERS: ORIGINS

The very first GERS report was published in 1992. Its purpose was to estimate the general government borrowing requirement for Scotland or, as GERS put it, Scotland's "fiscal deficit". This is the difference between the amount of expenditure undertaken by government on behalf of the people of Scotland, and the tax and other public revenues attributable to Scotland.

The motivation for producing the initial GERS was political. GERS had been commissioned by the Conservative Secretary of State for Scotland, Ian Lang: and this is what he said about it, in a leaked memorandum to John Major:

"I judge that it is just what is needed at present in our campaign to maintain the initiative and undermine the other parties. This initiative

could score against all of them."

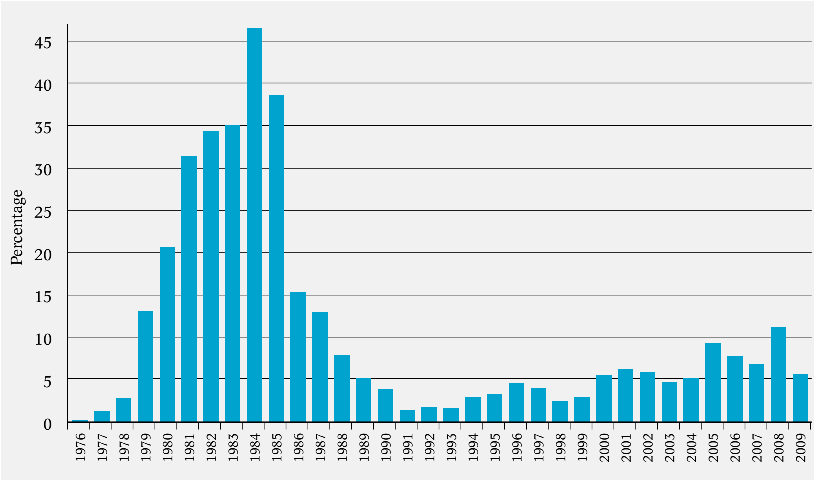
There was much that was unsatisfactory about the initial GERS. One crucial problem was with the very definition of what constituted Scotland. The primary definition that was used and the basis of the headline "fiscal deficit" figure, was of a Scotland that excluded revenues coming from the North Sea Continental Shelf, or "extra-regio". Early GERS reports did not neglect North Sea revenues entirely: but they were dealt with in a single table, illustrating a very wide range of possible variant percentages of North Sea oil allocated to Scotland. The effect of this was to encourage the view that there was uncertainty about what percentage of North Sea revenues Scotland might eventually receive on independence. In fact, this is not an issue for debate. The Geneva Convention, of which the UK is a founding signatory, is clear that the appropriate dividing line is based on the median line.

A justification for the GERS approach was given in GERS 1997-98: *"With the introduction of the European System of Accounts in 1995 (ESA95), in the Regional Accounts the regional shares of UK GDP are expressed relative to the UK less the "extra regio" territory. This replaces GDP excluding the Continental Shelf, which applied previously."*

However, the mandatory provisions of ESA95 are in fact concerned with ensuring that there is a standard basis of compiling accounts for European Community purposes. But the relevant part of the European Regulation which set up ESA95 clearly states that "*This Regulation does not oblige any Member State to use ESA95 in compiling accounts for its own purposes*": (Council regulation 2223/96). So, contrary to a widespread impression, ESA95 does not in any sense stipulate what approach should be adopted for handling offshore oil and gas revenues in a report like GERS.

To give some indication of just how significant the question of the treatment of oil revenues in GERS is, Figure 1 shows oil and gas tax revenues attributable to Scotland, as a percentage of Scotland's non-oil Gross Value Added, over the period 1976/77 to 2009/10. (Scottish oil revenues estimated by Kemp, 2011, based on the median line definition of the Scottish sector.)

FIGURE 1: ROYALTY AND TAX REVENUES FROM SCOTTISH SECTOR OF CONTINENTAL SHELF, AS A PERCENTAGE OF SCOTLAND'S NON-OIL GVA.



Another problem was that, with the concentration on producing a single figure for Scotland's "fiscal deficit", GERS failed to give supporting detail which would have placed this deficit figure in a more informative context. In particular, it failed to separate the overall deficit into its two components: net investment and current deficit. This split is important for determining how sustainable an overall deficit is likely to be. It is significant that when Gordon Brown came to define his "golden rule", he did so in terms of the UK's current deficit.

Yet another problem was that for many of the basic components in the calculation, early GERS reports were sparse on the detail of how these had actually been estimated: and in many cases UK figures were simply pro-rated to give crude estimates for Scotland.

After the production of the initial report, GERS then settled down into a long period of basically annual production – without major methodological or presentational changes, other than those necessitated by occasional alterations in government accounting practices. Unfortunately, with essentially the same analyses being repeated year after year, and with limited critical scrutiny being undertaken before the results were published, an increasing number of errors crept in. The magnitude of the resulting problems only became clear as outside researchers (including ourselves) probed into the basis of the GERS estimates from the late 1990s on.

Two examples illustrate the kind of problems that were uncovered.

First, it turned out that the Scottish Executive did not actually have access to the detailed figures in the Treasury's Public Expenditure Statistical Analysis (PESA) database, which is the fundamental source for the expenditure side of GERS. Only aggregate Treasury figures were provided to them, and so gross errors in the data went undetected. One such error we discovered related to the treatment of expenditure on items like prisons and nature protection in England. While this expenditure could be directly attributed to England, it could not be attributed to specific regions within England: in PESA this expenditure, which amounted to no less than £4.4 billion in 2003-04, was then mistakenly classified in exactly the same way as expenditure like defence, which could not be allocated to individual countries or regions within the UK. This meant that, in GERS, Scotland's expenditure was mistakenly increased by a population share of England's expenditure on prisons, etc.

Further, with the same analyses being repeated year after year, the original rationale for the approach being adopted was sometimes lost. For example, the Office for National Statistics, (ONS), were unable to tell us why, in the figures they produced each year to feed into GERS, Scotland was allocated an apparently quite unreasonable 15.7% of total UK government capital depreciation. For a fuller account of the above, and other, problems with the PESA database and GERS, see Cuthbert and Cuthbert, (2005 and 2007).

The upshot was that, by the mid 2000s, it was clear that GERS needed a thorough review: and this was duly undertaken by Scottish government statisticians in 2007. The revised GERS was a significant improvement: most of the errors which had been pointed out were corrected: much more detail was published: and expenditure was now split into its current and capital components, with estimates given both of the current budget balance and the overall net fiscal balance. And finally, the treatment of Scotland's offshore oil and gas reserves was brought much more fully into the mainstream of the publication, with each of the three variants now considered being given more or less equal weight in the main tables of the report. The three variants considered were – that Scotland receives a geographical share, currently 91%, of North Sea revenues, (the share of revenues as estimated by Kemp and Stephen, 2008, based on a median line determination of the Continental Shelf): the assumption that Scotland receives a per capita share of revenue: and the assumption that Scotland receives none. (Note that this last variant is still problematic since excluding North Sea revenues entirely from Scotland while keeping them in for the UK as a whole is inconsistent.)

Overall, therefore, GERS has been much improved through its recent extensive review. But this is not the end of the story. In particular, GERS still does not provide a sufficiently rounded picture to sustain a full and productive debate about Scotland's economic and constitutional future. To see why, we must first of all look at how the typical GERS debate currently proceeds – and this is the topic of our next section.

Before moving on to that discussion, however, the following figures, taken from GERS 2009-10, show Scotland's current budget, and net fiscal balance, as a percentage of GDP, for the years 2005-6 to 2009-10. (The net fiscal balance is the difference between total public sector spending, and public sector revenue, and is essentially what was described in the early GERS reports as Scotland's fiscal deficit.) The figures are shown under two assumptions about the allocation of oil and gas revenues: namely, that

a.) Scotland receives its geographical share of North Sea revenues.

b.) Scotland receives a population share of North Sea revenues.

Also shown are corresponding figures for the UK.

Given the data quality problems with GERS before its recent review, we have not given any figures from pre-review volumes of GERS.

TABLE 2: SCOTLAND AND UK: BALANCE ON CURRENT BUDGET AS PERCENTAGE OF GDP. (POSITIVE SIGN INDICATES SURPLUS)

Year	2005-06	2006-07	2007-08	2008-09	2009-10
Scotland: with geographical share of N. Sea	0.6	0.6	0.0	0.6	-6.8
Scotland: with per capita share of N. Sea	-6.3	-5.5	-5.6	-8.4	-12.6
U.K.	-1.1	-0.4	-0.3	-3.5	-7.6

TABLE 3: SCOTLAND AND UK: NET FISCAL BALANCE AS PERCENTAGE OF GDP.

Year	2005-06	2006-07	2007-08	2008-09	2009-10
Scotland: with geographical share of N. Sea	-1.7	-2.3	-2.6	-2.9	-10.6
Scotland: with per capita share of N. Sea	-9.1	-8.9	-8.7	-12.5	-17.0
U.K.	-2.9	-2.3	-2.4	-6.7	-11.1

SOURCES

GERS 2009-10, Table 3.3, and Box 3.3

The figures illustrate how Scotland, including its geographical share of offshore revenues, has been in balance or surplus on its current budget for four of the last five years – while the UK as a whole has been in deficit. On the overall net fiscal balance, Scotland has had a larger deficit than the UK in only one of the past five years. Without oil revenues, however, Scotland's current and overall deficits are a good deal higher than the UK's.

THE GERS DEBATE

As we have already noted, the annual debate prompted by GERS has been one of the features of political life in Scotland ever since the production of the first GERS report. This debate tends not to be a very edifying spectacle: as Iain Macwhirter put it, "the annual argument about the Gers tends to sound a little like rival crowds of football supporters jeering each other": (Macwhirter, 2008).

The typical GERS debate is not merely unedifying, it is also inherently sterile. This is because any conceivable piece of evidence can be used with equal conviction by both sides of the debate, as an argument in favour of their own position. If Scotland is doing badly, with a large (on whatever basis is convenient) fiscal deficit, then to the unionist side, this can be presented as evidence that Scotland could not stand on its own and also as a measure of the size of the "union dividend": but to the nationalists, this demonstrates economic and fiscal mismanagement under the union.

On the other hand, if Scotland is doing well, with a surplus, or relatively small deficit on the chosen measure, then the above arguments reverse. The nationalists can argue that this is evidence that Scotland could well go it alone – and the unionists can argue this shows how well Scotland is doing under the union.

It is not merely this duality that makes the GERS debate so sterile. There is also the fact that crucial factors which should condition the interpretation of the GERS figures tend to be forgotten. One such factor is that the aggregate total of GERS expenditure (that is, the sum of Total Managed Expenditure attributed to Scotland in GERS) is determined almost entirely by Westminster. This is because the Scottish budget (that part of Total Managed Expenditure over which the Scottish Parliament has responsibility for spending) is essentially determined by the operation of the Barnett formula. Most of the remaining parts of Total Managed Expenditure are determined by decisions of the UK Parliament on programmes like social security, or, in the case of non-identifiable expenditure, by attributing to Scotland a share of UK programmes like defence. So the total of expenditure in GERS says nothing about the total public expenditure resource which a Scottish government might choose to deploy if it were making the decisions about expenditure aggregates itself.

Similarly, on the revenue side, GERS is a description of the status quo and of the results of tax decisions made at Westminster. In itself, the GERS revenue figures say relatively little about the tax revenues which could be available to a Scottish government under the changed circumstances which would follow independence.

For all these reasons, the current debate which surrounds GERS is indeed inherently sterile. What could, and should, be done to move things forward?

GERS: THE WAY FORWARD

In GERS 2001-02, there is a telling sentence which gets to the heart of the sterility of the GERS debate: "*The primary objective is to create accounts for the inflow of resources to Scotland and the outflow of resources from Scotland that are directed through the UK Government's budgetary process.*" GERS, in other words, is by design a partial account of the flows to and from the Scottish economy – dealing only with those flows which are related to government.

Looking only at government related flows gives only an incomplete picture of the Scottish economy and its relations with the rest of the world. Consider the kind of information which is available for the UK economy. For the UK economy, the "Pink Book", produced annually by ONS shows in great detail all of the inflows and outflows of resources. What is shown in the Pink Book is a balanced account, showing not just the trade in goods and services and the income flows and current transfers which make up the UK's current account, but also the capital and investment flows which make up the UK's capital and financial accounts and which, by the double entry conventions of the National Accounts, must balance what is happening on the current account.

The value of having a proper set of balanced accounts can be seen from the analysis undertaken by Stephen Nickell, a former member of the Bank of England's monetary policy committee, when he set out in 2006 to consider the question of whether the UK's current account deficit was likely to be sustainable: (Nickell, 2006). In 2005, the UK's current account deficit (that is, the UK's deficit on trade in goods and services and on income flows and current transfers) was £31.9 billion, which is around 2.5% of GDP. Using the balanced accounts available in the Pink Book, Nickell demonstrated how this deficit was financed as the difference between two huge capital flows: essentially, in 2005, foreigners added £749.5 billion to their holdings of assets in the UK, whereas UK residents added £722 billion to their holdings of assets outside the UK. The difference between these figures, (which corresponds to an inflow of funds to the UK), is what financed the UK's current account deficit.

As Nickell pointed out, these capital and financial flows into and out of the UK economy are huge – each being of a magnitude equivalent to about two thirds of UK GDP. This led Nickell to the crucial insight that the UK economy was, in effect, operating like a very large bank. It is not our primary purpose here to analyse the implications of this: though it is worth remarking that the banking crisis of 2008 might lead one to take a less optimistic view of the sustainability of the UK's financial position than Nickell did, writing in 2006. The key point, for present purposes, is to note the kind of insight which a set of balanced accounts can give into the nature of an economy and the key issues which it faces.

In Scotland, by contrast, we have got the partial set of accounts provided by GERS. It is as if Ian Lang laid down the tracks in 1992: and although the tram travelling along these tracks after the 2008 GERS review is not as ramshackle and rickety as the original vehicle, it still has to travel along the direction laid down by the tracks. We would argue that the GERS debate will not go anywhere else until a balanced set of accounts is produced for Scotland along Pink Book lines.

Provision of such a balanced set of accounts for the external flows associated with the Scottish economy would require supplementing GERS with much better information on trade flows in goods and services, and also on private sector financial flows – both current and capital. It is quite clear that the production of a fully detailed set of accounts along these lines would be a major enterprise. But it is possible, from available information, to produce initial estimates of what some of the major aggregates in such a system of accounts would be. The results are instructive – and amply illustrate how the changes we are proposing would transform the debate.

Consider, for example, the initial estimate produced in 2010 by Scottish government statisticians, which gave a net outflow of private finance from the Scottish economy of £16.7 billion in 2008-09: (minutes of Scottish Economic Consultants Group Meeting, 18th October 2010.). It should be stressed that this is a very provisional estimate. Nevertheless this figure, with all its caveats, immediately alters one's perception of the Scottish economy. If (on the basis of Nickell's analysis) the UK economy is a large bank – the Scottish economy is a cash cow.

More specifically, the magnitude of the outflow of private finance immediately raises the following questions – which should be at the heart of economic and political debate in Scotland.

First, what steps are open to a Scottish government to maximise the benefit of this outflow for the Scottish economy? Clearly the options open to a Scottish government are greatly increased as one moves along the spectrum of increasing political power towards full independence: and with greater political power would come, of course, the option to alter energy taxation. But it would be a mistake to regard crude alteration of tax levels as being by any means the only available lever: other options would include tax incentives related to expenditure undertaken within the Scottish economy, for example, on research and development. And yet another option would be use of negotiating power in future licensing rounds for the exploitation of natural resources.

Secondly, there is the issue, not just of how Scotland could exercise more control of this outflow of resources – but of what should be done with it. In this respect, a very telling observation was made by the Nobel Laureate Joseph Stiglitz, when he was interviewed on Newsnight Scotland in 2010. In effect, he pointed out that a major capital asset, in the shape of offshore oil and gas reserves, was being converted into current consumption – rather than the more rational policy of converting part of the original asset into other forms of capital asset which would yield long term returns. One obvious candidate in the Scottish context would be to use some of the resources of the North Sea to provide Scotland with a capital asset in the form of a fully funded transmission network for renewable energy – so liberating Scotland from the grasp of the current, perverse National Grid charging model. Equally, another form of investment of an essentially capital nature would be to use some of the North Sea resources to fund investment in higher education.

This leads naturally to a final key issue. A large part of Scotland's current outflow of private finance is, of course, due to offshore oil and gas reserves. But as Scotland's renewable energy production grows, this position will change: and it will be vitally important to measure all of the flows associated with the renewable sector. One illustration of this can already be seen in relation to George Osborne's recent proposal to replace the Queen's Civil List subsidy with a percentage of the revenues generated by the Crown Estates. This proposal is likely, in fact, to have significant Scottish implications, given the prospective increase in the revenue coming to the Crown Estates from renewable energy generation leases issued for Scottish waters. (It should, of course, not be forgotten that the term "Crown Estates" is a misnomer: Crown Estates property in Scotland is legally the property of the Scottish people.) If there had been a fully integrated set of accounts along the lines that we are suggesting, then the implications of the Osborne proposal for Scotland would have been immediately apparent.

CONCLUSION

What we have shown in this chapter is how GERS, from its inception, was an essentially political document: and how, despite recent technical improvements, it remains the focus of an inherently sterile annual debate. The position is not, however, hopeless. What we argue is that the key to moving on to an altogether more productive debate is to replace the partial treatment in GERS with a full set of balanced accounts, showing all of the external flows into and out of the Scottish economy. For the UK, such a set of balanced accounts is available in the shape of the Pink Book – and such accounts would normally be expected to be available for any significant developed economy.

Production of such accounts would remove the political bias inherent in the current GERS format. Attention would then naturally focus on the very large outflow of private finance from Scotland: and on the question of how this outflow could best be utilised for the greater and lasting benefit of the Scottish economy. Availability of the kind of accounts we are suggesting would do nothing less than transform the current sterile debate about Scotland's future.

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CHAPTER 5
THE SCOTLAND BILL: WAY FORWARD OR CUL DE SAC?

BY PROFESSOR DREW SCOTT

1. INTRODUCTION

In this chapter, I review the provisions in the Scotland Bill changing the basis on which public spending by the devolved Scottish government will be financed and evaluate their significance from the perspective of Scotland's economic prospects. From 2016, the current arrangements, whereby spending by the devolved administration is financed entirely by a block grant assigned from Westminster, will be replaced by a funding regime in which part of the grant element (approximately 15%) will be replaced by revenues raised from the application of a new Scottish rate of income tax to be set annually by the Scottish Parliament. The block grant will be reduced by the amount yielded by this new tax, although it will continue to represent the lion's share of income accruing to the devolved administration.

It is generally acknowledged that the devolution of partial competence for setting income tax in Scotland – fiscal devolution – represents the centrepiece of the Scotland Bill. Indeed Michael Moore, Scottish Secretary of State responsible for the passage of the Bill through Westminster, is on record as describing the new arrangements as representing the largest transfer of fiscal powers from central Government since the creation of the United Kingdom. Leading political commentator Iain Macwhirter similarly enthused that the Bill "…heralds an unprecedented transfer of fiscal power to Holyrood" and will "…involve the greatest transfer of economic power to Scotland since the Act of Union in 1707". Setting aside the historical accuracy of this hyperbole (and I doubt anyone familiar with the economic powers assigned to the newly established Scottish Office in 1885 would agree with Mr Macwhirter's depiction) they serve to highlight the extent to which debate around the Bill has been shaped by its arguable historical – and constitutional – significance rather than by a close consideration of its implications for Scotland's economy. For instance, in response to concerns by a range of economists and business figures that the new arrangements might cause a potentially sharp decline in public spending in Scotland, Macwhirter again reflected a consensus view among the Bill's supporters that although there might be flaws in the proposals as they stand, "…there is plenty of time for these to be ironed out before the scheduled implementation date…". Needless to say, even yet, no thought seems to have been given by those championing the legislation, including the UK Government and the opposition parties in the Scottish Parliament, as to how such defects might be addressed.[26]

The Scotland Bill is, of course, being legislated by the UK Parliament – constitutional issues remaining a reserved competence under the 1998 Scotland Act. However, in addition to being scrutinised by both Houses of the UK Parliament, the Scotland Bill has also been subject to scrutiny by special committees of the Scottish Parliament. This conforms to inter-parliamentary procedures under the so-called Sewell convention whereby the Scottish Parliament passes a Legislative Consent Motion (LCM) in respect of legislation being enacted by Westminster but which requires action by the Scottish Parliament to give effect to that legislation. The scrutiny of the Bill in the Scottish Parliament determines the wording of the LCM on which the Scottish Parliament subsequently votes. And while the LCM voted on in Holyrood does not bind the Westminster parliament, it is generally accepted that if Westminster enact legislation which does not reflect the LCM this will represent something of a constitutional crisis. The last Scottish Parliament voted in favour of a LCM which endorsed the financial provisions of the Scotland Bill.[27] However, this was not the end of the matter. It was agreed that the Bill be returned to the Scottish Parliament to consider amendments made by the House of Commons. In June 2011, following the Scottish parliamentary elections which returned a majority SNP administration, a new Scotland Bill Committee was convened for this purpose and to consider a number of additional powers which the new Scottish government sought to incorporate in the Scotland Bill. The work of the second Scotland Bill Committee is expected to conclude by December 2011.

This chapter is organised as follows. In next section, I set out the financial provisions of the Scotland Bill and explore the rationale which

26 It is somewhat ironic that key provisions in a Bill promulgated on the need to assign greater responsibility to the Scottish Parliament should be considered in such an irresponsible manner.

27 The Report of the first Scotland Bill Committee (SP Paper 608) was tabled on 3 March 2011.

underpins these provisions. In section 3, I offer a number of criticisms of those provisions and consider how they might be addressed. In section 4, I review the economic case for a more comprehensive devolution of fiscal powers to the Scottish government, some of which are now under consideration. Section 5 offers some concluding thoughts.

2. THE FINANCIAL PROVISIONS OF THE SCOTLAND BILL

To understand the financial provisions of the Scotland Bill it is necessary first to consider the debate which preceded its publication. There are three related elements to this debate.

The first concerns a growing disenchantment – particularly among politicians representing constituencies in Wales and England – with the Barnett formula as the mechanism for determining the size of the block grant to be assigned to the devolved administrations. Introduced in 1978, the Barnett formula is a population-based formula used by the Treasury to determine the annual adjustment to the block grant to be assigned to the three devolved administrations. That formula is applied to the overall increase or decrease in UK government spending allocated to Whitehall departments that are responsible for policies that have been devolved[28] and the block grant adjusted accordingly. The base (grant) to which this annual adjustment is applied is not subject to a separate review, but is inherited from the previous year and is adjusted only in the event of new spending functions being devolved from Whitehall. One of the main advantages of the Barnett formula is that it is a relatively transparent and verifiable mechanism for assigning funds to the devolved administrations. The principal claim by critics of the Barnett regime is that it has, for a number of years, unfairly advantaged Scotland by supporting a higher level of per capita public spending than in other, less prosperous, parts of the UK. Instead they favour a funding formula for the devolved administrations that is based on their relative "needs" as revealed by objective indicators of economic and social welfare which, they insist, would result in a significant reduction in the block grant assigned to Scotland.[29] Successive UK governments have, over many years, resisted introducing a needs-based funding regime, doubtless conscious of the technical difficulties associated with establishing the relative "needs" of different jurisdictions and aware of the politically contentious nature of the results that may emerge. In the period since 1999, however, the critics have become more vociferous in their attack on the perceived inequity of

28 Currently the formula provides that Scotland receives (loses) 10.23% of the annual increase (decrease) in total public spending assigned to the relevant Whitehall departments.

29 In 2009 the House of Lords Select Committee on the Barnett Formula recommended the introduction of a needs-based mechanism for allocation of resources to the devolved administrations.

Barnett fuelled in part by a perception that successive Scottish governments have been able to finance spending policies that are unavailable in England.[30] Although in the absence of such a needs-based assessment, one cannot know the accuracy of these claims, they have been instrumental in undermining to a degree the integrity of the current arrangements for financing the devolved administrations.

The second element was increasing disaffection with a Scottish public spending regime in which the Scottish Parliament had complete autonomy for allocating public spending between devolved policies, but had virtually no responsibility for raising (through taxation) the funds which financed this spending. Critics argued that under this system there was no incentive for the Scottish Parliament not to spend the full amount of its grant even if, at the margin, this was producing no apparent benefit or, worse, effectively was 'crowding out' more efficient private sector expenditures. By requiring the Scottish Parliament to levy some element of the taxes on which its revenue depended would increase its financial accountability and, consequently, improve the efficiency of public spending in Scotland.[31] Moreover, it also meant that if the Scottish public collectively demanded a higher level of public service provision than the rest of the UK the Scottish Parliament had the necessary tax-raising power to finance this.

The third aspect was the election of a minority SNP Government in May 2007. Almost immediately the new government launched a public consultation – branded as a National Conversation – about Scotland's future constitutional position. The three broad positions identified were maintaining the status quo, increasing the powers of the Scottish Parliament and outright independence, with the outcome of this exercise expected to form the basis of a consultative referendum on independence to be held in the lifetime of that parliament. Scotland's pro-union opposition parties responded to this initiative by establishing a separate Commission on Scottish Devolution under the chairmanship of Sir Kenneth Calman. That Commission, which was also supported by the then UK Labour government, was tasked with reviewing the provisions of the 1998 Scotland Act and bringing forward recommendations that might improve the devolution settlement, including the financial accountability of the Scottish Parliament. In the event, the proposals brought forward by the Calman Commission in this latter regard were adopted by the UK Government and included virtually intact in the Scotland Bill.

30 Devolution permits the devolved administrations to make different choices vis-à-vis public spending than the rest of the UK and this – rather than higher levels of funding – is what these policies reflect.

31 For a comprehensive review of this argument see Hallwood, P. and MacDonald, R. (2009), especially Chpt. 3

The final report of the Calman Commission was published in June 2009[32] and included recommendations for changing the basis on which the public spending of the Scottish government should be financed. The Commission's principal objective in bringing forward its proposals was to increase the accountability of the Scottish Parliament for its budgetary policies. This would be achieved by funding part of the Parliament's total budget from revenues accruing from taxes directly levied by that Parliament. To achieve this, the Commission proposed introducing a new Scottish income tax – initially set at a flat rate 10p for basic and higher rates of income tax – which would be set annually by the Parliament with the yield from this tax accruing directly to the devolved administration. This would require a reduction in the rate of income tax levied in Scotland by the UK Government by the same amount. For the year in which the new arrangement began, the block grant would be reduced by an amount equivalent to the yield from the application of a 10p Scottish income tax. In subsequent years, the total funds accruing to the Scottish government would then comprise two separate elements – a now reduced block grant, the annual change in which will continue to be determined by the Barnett formula, plus receipts generated by the levying of the Scottish income tax. By changing the rate of Scottish income tax, the Scottish Parliament would be able to determine its own level of public spending and be fully accountable to the Scottish public for its decision. Finally, the Commission agreed that in due course the block grant regime for financing the devolved administrations should be more closely aligned with the relative needs of the different jurisdictions.

In developing its proposal, the Calman Commission was advised by an Independent Expert Group of outside academics which considered the pros and cons of alternative arrangements for financing the devolved Scottish administration. Their deliberations were published as a separate Report late in 2008.[33] In the event, this independent Report was to become highly prominent in the debates that followed the publication of the Commission's recommendations and was frequently cited as the source of evidence underpinning the Commission's specific proposals. Moreover, it was additionally claimed to provide an authoritative rebuttal of alternative proposals that involved a more comprehensive devolution of fiscal powers to the Scottish government. As even a cursory reading of that Report reveals, however, it offers little more than a descriptive and highly generalised overview of the (comparative) literature on 'fiscal federalism', includes almost no economic analysis of alternative models of tax devolution and provides neither commentary on nor analysis of the possible economic implications of the funding model later adopted by the Calman Commission. Regardless of

32 Calman Commission (2009)

33 Calman Commission Independent Expert Group (2008)

the fact that, insofar as one can detect, no such economic analysis was ever undertaken, the recommendations of the Commission were quickly accepted as policy by both the UK government and the main opposition political parties in the Scottish Parliament.

The Commission recognised that its proposal to partly fund the Scottish budget with this “own resource” income tax element did create the possibility that Scotland’s public spending would be subject to a degree of revenue uncertainty. This arises because if the level of economic activity in Scotland unexpectedly fell, this would cause a fall in income tax revenues with the result that the government would be unable to meet its immediate spending commitments. To address this potential problem, and “smooth” its revenue, the Scottish government may find it necessary to borrow to cover any such unanticipated revenue shortfall. However despite this, and without offering an explanation, the Commission asserted that the existing borrowing provision of £500 million included in the 1998 Scotland Act was sufficient for this purpose and no additional powers to borrow to finance current spending were required. The Commission did recommend the introduction of a limited power for the Scottish government to borrow to finance capital investment.

As noted, the report of the Calman Commission provided the blueprint for the proposals tabled by the Labour government in their White Paper entitled ‘Scotland’s Future in the United Kingdom’ published in November 2009. In the event, it fell to the Tory-Lib Dem coalition government elected in May 2010 to bring forward the relevant legislation in the form of the Scotland Bill. The financial provisions of that Bill similarly adhered very closely to the proposals made by the Calman Commission.[34]

A new Scottish rate of income tax would be introduced in 2016, initially set at 10p, and the block grant adjusted by an amount equivalent to the revenue this would generate.[35] The Scottish Parliament would be empowered to set this Scottish income tax at whatever rate it chose, and the revenues yielded by the tax would accrue directly to the Scottish budget. If it opted to increase Scottish income tax, the immediate effect would be to raise new funds; if it lowered the rate, the amount available to finance spending on devolved policies would decline. However, devolved spending cannot be dependent on real-time tax receipts, which tend to be collected towards the end of the financial year in question. This, along with the possibility of an unanticipated decline in tax receipts occurring (for instance

34 Details of the Government’s financial proposals are set out in a Command Paper (Cmnd 7973) ‘Strengthening Scotland’s Future’ presented to the UK Parliament by Secretary of State Michael Moore in November 2010.

35 Consequently under the new funding formula the annual change in Scotland’s budget revenue will differ from that produced by the ‘full’ Barnett system, even if the Scottish Parliament opts not to change the rate of Scottish income tax from its initial rate of 10p.

following an unexpected economic shock) would mean that public spending in any financial year would be exposed to considerable risk of interruption and this would be de-stabilising for the economy as a whole. Accordingly, at the beginning of every Comprehensive Spending Review period the Office of Budget Responsibility (OBR) will provide a forecast of annual Scottish income tax receipts and this forecast amount will be assigned to the Scottish budget for that period, thereby providing the Scottish government with a degree of financial security in planning future public spending. This is more or less identical to the arrangements for determining the size of the Scottish block grant – and indeed all departmental spending across Whitehall.

However, given that forecasts invariably prove to be wrong, an adjustment will be required – to be made within 12 months of the end of the financial year – to reconcile forecast and outturn income tax revenue data. Thus if the OBR has over-estimated Scotland's income tax yield – and therefore assigned too much to the Scottish budget – the overpayment will be repaid from the Scottish budget in the following year: an underestimate will be compensated by an additional payment by the Treasury in that year. Utilising forecasts of tax revenues is an attempt to avoid two problematic issues. First, it avoids public spending in any year being dependent on tax revenues accruing in the same year. This is undesirable insofar as the timing of tax collecting is variable and because it leaves planned public spending susceptible to an unanticipated fall in tax receipts – for example because of an unexpected increase in the level of unemployment. Second, and related, it was argued that this arrangement eliminated the need for the Scottish government to have the type of borrowing powers to support current spending plans that governments usually utilise in order to "smooth" public spending given the vagaries of tax revenue flows. Accordingly, the Bill did not propose altering the terms of the 1998 Scotland Act to increase – from £500 million – the capacity of the Scottish government to borrow to finance current spending. The UK government insisted this provided sufficient headroom to offset any unexpected decline in the revenues accruing from the two other (minor) taxes being devolved – namely landfill tax and stamp duty. Finally, the Scotland Bill provides for the Scottish government to borrow (from the UK government) in order to finance capital investment. This borrowing will be limited to 10% of the Scottish capital budget in any single year (estimated at £230 million in 2014/15) subject to an overall ceiling of £2.2 billion.

The UK government contends that the financial provisions of the Scotland Bill will significantly increase the accountability of the Scottish Parliament for the expenditure decisions it makes. It claims that once the new regime is implemented the total of current spending decided by taxes determined in Scotland will have risen from 14% to 35%, although critics claim the true share is considerably less than this.[36] Supporters of the Bill also insist that it equips the Scottish Parliament with the power to raise the rate of income tax – and, with UK Government permission – introduce new taxes in order to fund an increase in public services provision if this is what the voters in Scotland want. It is worth emphasising that no claim is made by the UK government that the Scotland Bill will increase the economic levers at the disposal of the Scottish government. There is little doubt that this is neither an intention of the Bill, nor an underlying aim of the UK government. Instead the financial provisions are designed solely to increase the accountability of the Scottish Parliament.[37]

3. A CRITIQUE OF THE BILL'S FINANCIAL PROVISIONS

The financial provisions of the Scotland Bill can be criticised from two different perspectives. The first is a critique of the likely impact of the Bill on the Scottish budget and so public spending on devolved matters in Scotland. Here the debate revolves around a number of operational problems with the Bill and its implications for open and transparent government. I address these issues in this section. A second critique of the financial proposals focuses not on what the Bill does provide for, but what is missing from its provisions, including the failure of the Scotland Bill to provide any new economic levers to the devolved Scottish government with which to tackle what many regard as deep-seated weaknesses in our economy – some of which are discussed in other chapters in this volume. That second set of issues is considered in the subsequent section.

One of the main concerns with the financial provisions of the Bill is the extent to which it could trigger a reduction in the revenues available to the Scottish Parliament – the so-called 'deflationary bias'. Under the Bill, and as noted earlier, the rate at which the funds available to the Scottish budget grow annually will henceforth be determined by (i) the rate of growth of the Barnett consequential – this being determined by the UK government, at a rate related to the growth in public spending for the UK as a whole – and (ii) the rate of growth of the yield from Scottish income tax – this being determined by the rate of growth of the Scottish income tax base multiplied

36 The starting figure of 14% is misleading as it includes council tax revenues which are not set by the Scottish Parliament. In evidence to the second Scotland Bill Committee on 13 September 2011 Sir Kenneth Calman suggested the increase in the financial accountability of the Parliament would be a mere 15%.

37 For many economists, the author included, this is the single biggest defect of the Scotland Bill.

by the rate at which Scottish income tax is levied.[38] If the new funding regime is to provide at least as much funding to the Scottish budget as the current (full Barnett) regime without any increase in the level of Scottish taxes, the rate of growth of the new tax revenue component has to be at least equal to the rate of growth of the Barnett consequential "block" that it has replaced.

It is, of course, impossible to forecast either of these elements as the new regime seems unlikely to be fully operational before 2018. We have no idea what the growth of UK public spending (for the grant element) and the growth of incomes (for the tax element) will be that far ahead. However, we can look at what would have happened to the Scottish budget had the prospective funding regime been in place from 1999-00 when devolution was introduced. Data provided by the Scottish government assesses the impact on the total Scottish DEL had the proposed funding regime been in place over the period 1999-00 to 2010-11. In that event, there would have been an accumulated shortfall of almost £8bn compared to what occurred under the current (full Barnett) financing model.[39] This is a measure of the deflationary bias that could arise under the proposed funding arrangements and reflects the fact that the rate of growth of UK public spending exceeded the rate of growth of Scotland's income tax revenues. The deep public spending cuts that have already been announced by the UK government have led to suggestions that, in the future, this situation will be reversed and – under the new arrangements – tax revenues will grow faster than UK public spending with the result that the Scottish budget will be higher than otherwise. However, current economic trends suggest this will not be the case – indeed what could now be expected to occur is that the delayed economic recovery will result in a situation in which both tax revenues and public spending are declining and what matters then is which is declining fastest. If tax revenues fall at the faster rate a deflationary bias will still arise.

Linked to this matter is the adequacy of the borrowing provisions – limited to £500 million in total subject to an annual ceiling of £200 million – to permit the Scottish government to borrow in the event of an unanticipated shortfall in tax revenues. In effect, this borrowing will be required principally where a refund to the Treasury is necessary as a consequence of their

38 There is much confusion about the revenue implications of the proposed regime. The new arrangements will only be revenue-neutral with respect to the Scottish budget in the first year of its operation. Thereafter, Scotland's budget revenue will diverge from what would have been received under the 'full' Barnett regime even if the Scottish Parliament does not change the 10p starting rate of income tax.

39 Needless to say this figure has been disputed by the Scotland Office which asserts the true losses to the Scottish budget would have been much smaller – at £691 million – although it seems to accept that there would have been losses. An added problem in looking to the future is the continuing lack of clarity over the precise mechanism the UK government will use to calculate the initial adjustment to the block grant and index it thereafter.

previously overestimating the yield from the Scottish rate of income tax. In the absence of an adequate (or indeed any) borrowing facility to offset a shortfall in actual over projected income tax revenue, a refund could only be funded by an immediate cut in public spending to the detriment of policies for which funding had been committed on the basis of anticipated revenues. Based on the latest estimate available for Scottish income tax receipts, the proposed annual borrowing facility of £200 million represents approximately 5% of the Scottish government's share of income tax receipts. Accordingly, if the OBR overestimates this share by more than 5% in any one year, the borrowing facility alone will be inadequate to finance the reconciliation that will be required from the following year's budget. And this borrowing facility will have to accommodate any overestimate of revenues from stamp duty and landfill taxes.

Under the provisions, non-capital borrowing is only possible against forecast errors. Over the decade before the current recession, 1997-2007, the UK government's track record for income tax receipts is one of forecast errors that range between +7% to -4%, with an average of +1.1%. Since borrowing will follow from overestimates, this means the Scottish government will need to cut spending or borrow every year on average and should expect to exhaust its borrowing limit (of £500 million) several times in a decade.

Of course, no borrowing is possible if a decline in income tax revenue is due to (fully anticipated) bad economic shocks rather than forecasting errors. This is potentially problematic for maintaining planned levels of public spending. For example, according to calculations by the Scotland Office, the adverse impact of the 2008-2010 recession on Scotland's income tax receipts would have resulted in the Scottish budget being reduced by £748m and £559m in 2008 and 2009 respectively. Under the proposed legislation, this decline in revenue could not be offset by government borrowing (i.e. it did not result from a forecasting error), meaning that – given such adverse shocks do occur – the more accurate are the tax revenue forecasts the more volatile will Scottish revenues become and the more the Scottish government will be obliged to cut spending and social support in a downturn. Therefore, not only do the Bill's borrowing provisions offer only very limited protection against forecast errors, they provide none whatsoever against unexpected economic shocks. In this scenario, public spending in Scotland is bound to move pro-cyclically and this will simply amplify the severity of the initial economic shock – thereby adding to unemployment and lost output and delaying any subsequent economic upturn.[40] The operation of the 'forecast and reconciliation' mechanism with respect to the new income tax element

40 Should the economic shock be beneficial to Scotland's economy then revenues (and spending) will rise which is also pro-cyclical and undesirable as it may exaggerate the economic upturn already underway.

of the Scottish budget therefore has the potential to introduce a significant degree of dynamic instability into the cycle of public spending in Scotland.

This problem could be resolved by providing the Scottish government with a general power to borrow in order to smooth revenue flows. Alternatively, a mechanism could be introduced that placed a lower limit on the extent to which the impact of an adverse economic shock on income tax revenues would be allowed to reduce the overall Scottish budget.[41] The danger is that, in the absence of any resolution to this matter, it is perfectly conceivable that the dynamic instability described above could severely damage Scotland's long term economic strategy.

A number of additional, often technical, criticisms have been made of the financial provisions of the Scotland Bill. For example, much will rest on the forecasting method to be employed by the OBR to estimate Scotland's future income tax revenues. Because of significant differences in average income levels, income distribution and employment patterns in Scotland compared to the rest of the UK, it is unlikely assigning Scotland a per capita share of UK estimated income tax yield will be particularly reliable. And, as noted above, because the reconciliation between forecast and outturn revenue flows has significant public spending implications, it is important these forecasts are as accurate as possible. Other than general assurances a suitable forecasting regime will be developed, no detail about this – or the role the Scottish government might take in calibrating an appropriate forecasting model – have been forthcoming. Similarly, under the proposals the Scottish Parliament will not be permitted to vary the rates at which Scotland's income tax is levied at different tax bands. Clearly, this means that any increase in the Scottish rate of income tax will be regressive, in that it will represent a higher percentage increase for those on lower incomes compared to higher income groups.

The Scotland Bill proposals have also been implicitly criticised by the Holtham Committee, an independent expert group established by the Welsh Assembly to review future funding options for the devolved Welsh Assembly. The thrust of the Holtham critique is that the proposed regime will leave Scotland's budget exposed to tax revenue risks that are not associated with any decision taken by the Scottish Parliament. For instance, if the UK government alters income tax bands, or if there is a UK-wide economic shock that reduces, inter alia, Scotland's income tax base, both events will impact on the 'own resource' tax revenues accruing to the Scottish budget despite the fact that neither is a consequence of decisions made by the Scottish Parliament. As Holtham notes, it seems inappropriate that the budgets of devolved administrations should be exposed to revenue risks which they are

41 This would take the form of a 'circuit-breaker' such that any forecast error exceeding, say, 1% of the Scottish budget would be written off by the Treasury.

unable, given their powers, to hedge against.[42]

Critics of the proposals to change the way in which the Scottish budget is financed agree that the prospective regime has the potential to trigger a significant decline in Scottish public spending and to introduce an undesirable degree of volatility to public spending that would amplify rather than dampen the Scottish economic cycle. In that regard, it should be noted that, in economic terms at least, an unexpected increase in the size of Scotland's budget is no more desirable than an unexpected shortfall. In both cases, the impact will be to adjust public spending in a pro-cyclical manner, a response that few economists would agree to be sensible. However, the deeper concern is that a likely consequence of the new provisions will be to reduce the Scottish budget at the middle of the present decade, quite possibly during a period of continued low economic growth in Scotland – and beyond – serving only to deepen the deflationary cycle. And if Scottish public spending is to be protected in that event, this will require the rate of income tax levied in Scotland to rise above that levied in the rest of the UK. Once again, this is likely to worsen the economic situation rather than to improve it.

It is worth stressing that the debate is not one involving the desirable level of public spending in Scotland. There are some economists who may insist that the Scottish government should curtail public spending in any event and of course that is a perfectly legitimate argument. But it does not follow from this argument that the financial mechanism being proposed is the appropriate way of achieving this outcome. Indeed, given its potential to introduce significant instabilities to public spending, the overall economic consequences are set to be damaging.

Finally, it is worth considering the implications of the proposed financial regime from the perspective of 'good governance'. Although the Barnett formula has attracted criticism, almost all commentators agree that it has the virtue of being transparent, objective and comparatively verifiable. And this will continue to be the case for that segment of the block grant that continues to be funded by this arrangement. However, I suspect few will agree that the new provisions, which will determine a significant segment of the Scottish budget, have similar characteristics. Debates over forecasts are likely to arise, while UK-wide income tax decisions that continue to be made at Westminster (e.g. the basic rate of tax; the level of tax allowances; the rates applied at each tax band) will now become issues of legitimate concern to the Scottish government as these collectively will determine the tax base on

42 In response to this Michael Moore has insisted that the new arrangements will be covered by a 'no detriment' clause such that the Scottish budget will not suffer as a consequence of a UK policy decision over income tax. However, as in key points of detail, no information on how this could operate have been made available.

which the new Scottish income tax is levied. Is the UK government prepared to discuss these issues with the devolved government ahead of any change in the rules? One suspects not and this could easily become a source of tension between the respective administrations.

4. THE WAY FORWARD?

Although the Scotland Bill's financial provisions have been criticised from the perspective of their likely effects on Scotland's economy, arguably the dominant critique revolves around what the Bill fails to do rather than what it does. Does the Scotland Bill offer the way forward for Scotland's government in addressing the deep-seated problems of the Scottish economy? If not, then why not? And is the Bill in essence a 'missed opportunity'? I consider these issues in this section.

Arguably, the most important criticism of the Bill is that it singularly fails to increase the economic powers at the disposal of the Scottish government that could be applied to enhancing Scotland's economic performance.[43] In response to this criticism both the Calman Commission and the UK government insist that this was never an intention of the constitutional review exercise or indeed of the proposals that have come forward. Instead, their aim was solely to increase the accountability of the Scottish Parliament for the revenues it spent – presumably with a view to ensuring Scotland's public spending was applied to maximum possible efficiency. However if this was the objective, then why limit this increased accountability to such a small percentage of total public spending? By devolving greater powers over income tax, or indeed by devolving additional taxes to those set out in the Scotland Bill, then logically more accountability and even higher efficiency gains could be achieved.[44] Proponents of this approach argue that both corporation tax and taxes applied to North Sea petroleum exploitation could be devolved to achieve this result. The case advanced against this option is that the revenues accruing from these taxes are sufficiently volatile as to undermine the overall stability of the Scottish budget thereby introducing an unacceptable degree of uncertainty into Scotland's public spending. It is worth noting that a previous argument against extensive fiscal devolution (i.e. fiscal autonomy) that Scotland's total public spending simply could not be financed from tax revenues accruing from economic activity in Scotland (including North Sea oil exploitation) has been shown (by Scottish government statistics on revenue and expenditure in Scotland) to be incorrect.

43 Most economists would agree that, in itself, income tax is a very blunt – and indeed undesirable – policy instrument in influencing the underlying performance of an economy.

44 See for example Reform Scotland (2011)

The proposition that economic efficiency is maximised when governments are required to finance their public spending only from taxes they themselves impose and borrowing for which they are entirely responsible (i.e. the government faces a 'hard budget constraint') is one to which almost all economists would adhere. However, the proposition that the relationship between increasing economic efficiency and increasing fiscal responsibility is linear – such that an X% increase in fiscal responsibility will produce an equivalent X% increase in economic efficiency – enjoys no such consensus. Consequently, it is unclear what public spending efficiency gains one might expect to result from the marginal increase in the accountability of the Scottish Parliament provided for in the Scotland Bill. At the very least, one must be able to argue – if not conclusively demonstrate – that these gains will be sufficient to offset the potential economic costs discussed in the preceding section.

However, the main debate revolves around the failure of the Bill to provide for the transfer of additional economic levers to enable the Scottish government to develop policies that will improve Scotland's economic performance. Most attention in this respect has focused on the role that devolving corporation tax could play in this regard, although this is far from being the only tax which impacts on the economy's overall economic performance and which could be devolved. Moreover, the relative paucity of the borrowing powers set out in the Bill and the rejection of the Scottish government's proposal that it be able to issue its own debt instruments, has also been criticised.

It is beyond the scope of this chapter to review the academic debate on the pros and cons of fiscal autonomy for Scotland. That argument has been rehearsed elsewhere and it was touched upon – though not developed – by the independent expert group advising the Calman Commission. It was also addressed – though once again in little considered detail – by the first Scotland Bill Committee and is being reconsidered by its successor Committee in the current Parliament. And while the original Scotland Bill conceded the possibility that lowering the rate of corporation tax or adjusting the tax base on which corporation tax is levied could be used to influence the level of investment activity (including inward investment) in Scotland – a proposition with which few economists would disagree in principle – it was not appropriate for this policy lever to be devolved. That Committee's reservations were based on two additional concerns. First, devolving too many taxes would reduce considerably the role of the block grant in financing devolved spending and this would jeopardise the stability of the Scottish budget. Second, devolving corporation tax would result in Scotland triggering intra-UK tax competition which would see rates fall across the UK to the detriment of public spending and/or result in Scotland 'poaching' mobile capital from the rest of the UK and become domiciled in a lower tax jurisdiction.[45] It is fair to say that no evidence in support of either proposition was offered; rather both propositions were deemed to be self-evident truths.[46] It is also worth noting that it takes at least two governments to engage in tax competition, and thus far the UK government has not implied it would engage in competition with a devolved administration that – if it could – decided to lower the rate at which it applied this tax.

Along with Andrew Hughes Hallett, my own position has been set out in an earlier paper in which we advocated a radical shift to full fiscal autonomy for Scotland. Our argument revolved around the benefits this could bring for Scotland's economic management.[47] The core proposition in that paper is that devolving full authority over virtually all taxes levied in Scotland (with the exception of VAT) (and public services delivered in Scotland) would provide the Scottish government with the economic policy levers it requires in order to maximise the growth and employment performance of the economy. The Scottish government would then be responsible for raising, through taxation, all the revenue required to finance Scotland's public spending and cover the net remittances to the UK government required to pay for Scotland's consumption of those services that continue to be provided centrally – e.g. defence, foreign policy, etc.[48] Scotland's government would also be responsible for financing any deficit of income over expenditure by issuing debt instruments and, subsequently, of managing its own domestic debt levels. However, as we discuss below this does not imply that Scotland would be fiscally independent. Various inter-governmental agreements and institutions would be required in order to ensure that Scotland's fiscal autonomy was consistent with macroeconomic stability for the UK as a whole.

Equipping Scotland's government with comprehensive taxation powers would enable it to construct a tax regime that was optimal from the perspective of the long term management of the economy. Some of the likely effects of tax autonomy are well rehearsed – such as the impact of lowering

45 Testifying to its muddled thinking on this issue the Committee did suggest that devolving corporation tax to Scotland would become desirable if corporation tax powers were devolved to Northern Ireland. But if such powers are undesirable per se for the devolved Scottish administration for reasons stated by that Committee, there is no reason why that situation changes – in economic terms – if corporation tax powers are devolved to Northern Ireland.

46 In fact on the first point historically the standard deviation of income tax has exceeded significantly that of corporation tax – meaning that, somewhat ironically, volatility of the to-be-devolved income tax is to be feared much more than corporation tax volatility.

47 See Hughes Hallett & Scott (2010) for a comprehensive statement of this.

48 Precisely which public services should remain under the control of the UK government would depend, in part, on economies in the provision of some services that can only be exploited by centralised delivery.

the rate of corporation tax on growing domestic – and encouraging inward – investment, or changing the base on which the tax is applied to support, for instance, research and development activities. Other benefits have had much less discussion. Broadly stated, the more extensive the control a government has over taxation and spending within its jurisdiction then the better able it is to design a tax regime that is optimal from the perspective of the economic challenges and opportunities it faces and the broader societal objectives it seeks to realise.[49]

Interestingly, opponents of fiscal autonomy for Scotland tend not to dispute the proposition that it would add to the economic policy levers to which a government had recourse in order to better manage the economy. Rather they object that it is not desirable for other reasons –that Scotland could not afford to be fiscally autonomous; that fiscal autonomy is equivalent to political independence; that fiscal autonomy would be economically destabilising from the Scottish and UK perspective; that UK fiscal policy is in any event optimal from the perspective of the Scottish economy.

The first two propositions can be fairly easily refuted. Official statistics in recent years have demonstrated that Scotland's economy would be eminently capable of generating sufficient income to cover its expenditure on a sustainable basis.[50] This does not mean that Scotland's finances would permanently record a financial surplus, but the data does demonstrate that the scale of the budget deficit associated with the current economic slowdown would lie within the range associated with the better performing EU member states. The argument that fiscal autonomy is equivalent to political independence can be equally speedily dismissed. Simply, there is no example anywhere in the world in which the decentralisation of fiscal policy has resulted in political independence on the part of the devolved administration. One can point to examples of very high levels of fiscal decentralisation – such as in Spain or Switzerland – to demonstrate this point.

The other two objections warrant closer attention. The extent to which fiscal autonomy might result in economic (and social) instability both for Scotland and the UK depends largely on the inter-governmental coordination measures and policy constraints that accompany fiscal decentralisation. As we discussed in our earlier paper, fiscal autonomy within the context of overall UK economic policy requires both the creation of a dedicated institution for inter-governmental macroeconomic policy (including tax

49 The recent review of the UK tax regime conducted by Professor Sir James Mirlees offers a scathing indictment of the adverse effects of elements of the current UK tax system on economic development. See Mirlees Review (2011)

50 See GERS (2011) for the latest data available. Hughes Hallett & Scott (2010) provide detailed calculations demonstrating this point.

setting) coordination and a specific debt protocol to ensure the requisite degree of financial prudence is exercised by the Scottish government.[51] Moreover, we advocated the creation of an independent fiscal authority which would oversee, and if necessary publicly comment on, the fiscal policy decisions taken by the Scottish government.

The proposition that the fiscal policy decisions taken by the UK government are those most appropriate for Scotland's economic circumstances is not sustainable. It is clear from even a cursory review of the data that Scotland's economy has, persistently though not always, under-performed the UK average. The current recession is likely to see a significant widening of this performance (employment and economic growth) gap. The divergence of Scotland's economy from the UK average (and significantly from the performance of the UK's stronger performing regions) reflects a number of factors that could be addressed in the context of fiscal autonomy. Differences in economic structures, endowments and resources; differences in the way the economy responds to external economic shocks; differences in the economy's position on the economic cycle; and differences in preferences or public service needs all contribute to explaining Scotland's relative economic underperformance over many years. Each of these factors requires specific interventions and in each case fiscal policy would constitute a significant economic lever.

A final objection to radically increasing Scotland's fiscal responsibility is that the Scottish government already has the requisite range of economic policy levers at its disposal with which to improve the underlying rate of economic growth. It certainly is the case that the current array of devolved policy competences are necessary to influence the rate of economic growth in Scotland. The question is whether or not these are sufficient. It is important to recognise that, with the exception of the power to vary by 3p the rate of income tax levied in Scotland, the Scotland Bill of 1998 did not transfer any new economic powers to the devolved government. The economic policies over which the current Scottish government and Parliament have authority are precisely the same as the former Scottish Office had for many years before devolution. And, on average, our economic performance has not markedly changed over this period relative to the rest of the UK. In other words, the criticism that any particular devolved government is not using the powers it already has sufficiently ably to generate higher rates of economic growth just cannot be sustained. These same powers have been exercised by many UK-wide and devolved governments of every political persuasion without notably changing the long term trend position of the Scottish economy vis-à-

51 This avoids a situation arising whereby a Scottish government might incur excessive debt which the markets nonetheless finance on the assumption if necessary that it will be honoured by the UK government.

vis the UK. This suggests that it is not the use of the policy instruments that is the source of the problem, but the lack of control over the key economic policy levers, including taxation (which influences investment flows and new firm start-up rates) and borrowing for capital investment.

5. CONCLUDING THOUGHTS

With the return of a majority SNP government in May 2011, a second Scotland Bill Committee of the Scottish Parliament has been convened both to re-visit some of the issues that were not adequately scrutinised by the original Committee convened by former MSP Wendy Alexander (in particular the income tax devolution proposal) and to re-open the question of whether additional fiscal powers – especially corporation tax – should be devolved to the Scottish Parliament. The work of that Committee is to be completed by the end of 2011.

The May election also prompted a shift on the part of the UK government with respect to the Scotland Bill. In June 2011, the UK government announced it was prepared to bring forward the implementation of the capital borrowing powers in the Bill and to examine the case for a Scottish government to issue its own debt instruments in the form of government bonds. The UK government also appeared to recognise some of the defects in its proposals for the devolution of income tax and would look again at the detail of their original scheme. However, the UK government remained steadfast in its opposition to going any further towards fiscal devolution than set out in the Bill, particularly with regard to competence over corporation tax. Of course, in this respect it is not only Scotland that is seeking progress. The devolved administration in Northern Ireland is also campaigning for a transfer of authority to change the rate at which corporation tax is levied in the province in order that it might compete more effectively for inward investment with the Republic of Ireland where corporation tax is levied at only 12.5%.

In Scotland, almost all public debate since 1999 about the powers which should be devolved to the Scottish Parliament have been clouded by political considerations. That it is the SNP which is seeking additional fiscal powers is taken by many political opponents as evidence of the imprudence of transferring such powers on the basis that this “plays into the hands of the nationalists”. Of course, no one is arguing that the simple transfer of economic policy levers in and of itself will improve economic performance. Bad policies will produce bad results regardless – and arguably the less competent the government the fewer powers should it be given. But if economic policies are properly implemented and are based on good economic theory and a sufficient understanding of the workings of an economy, they will deliver good results. However, that requires that the government has access to the appropriate economic policy levers. At present, I do not believe the Scottish government has the powers it needs, particularly the fiscal powers. Therefore, it is difficult to avoid the conclusion that while the Scotland Bill might not exactly be a 'cul de sac', most certainly, as it presently stands, it does not point the correct way forward.

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CHAPTER 6
THE SCOTTISH ECONOMY: SEEKING AN ADVANTAGE

BY PROFESSOR DAVID BELL

INTRODUCTION

Following the May 2011 election, the possibility of an independent Scotland has increased dramatically. An independent Scotland will have to develop economic policies that are very unfamiliar. Obvious examples are regulation and monetary policy. Yet though the Scottish Parliament will control more of the levers of economic governance, the economic realities of the world economy will not change because Scotland is independent. National economies do not exist in isolation: they trade with each other and exchange labour and capital. If living standards are to improve and public services to be paid for, the Scottish economy will have to grow. There is no simple recipe for achieving growth. Countries start with different resource endowments and different economic, cultural and political histories. What may work in some jurisdictions will not work in others. But this does not mean that one should not continually seek to learn how best to set an environment in which businesses can grow and prosper. Going back to the 19th century economist, David Ricardo, the key is finding those areas of production in which Scotland has already, or can develop, a comparative advantage.

A new Scottish government will have to take as its starting point the Scottish economy as it is, warts and all. Currently Scotland is in the midst of recovering from the largest drop in output since the Great Depression. Large parts of the financial sector, which was the engine of growth in the last decade, are in a state of nationalised paralysis. Unemployment, particularly youth unemployment, is disturbingly high. Public services are trying to reorient themselves to an environment in which the headlong growth of the last 10 years has been summarily reversed.

But there are also a set of longer term issues that will influence Scotland's growth. These principally concern its competitiveness, the ultimate determinant of comparative advantage. Thus, Scotland will inherit:

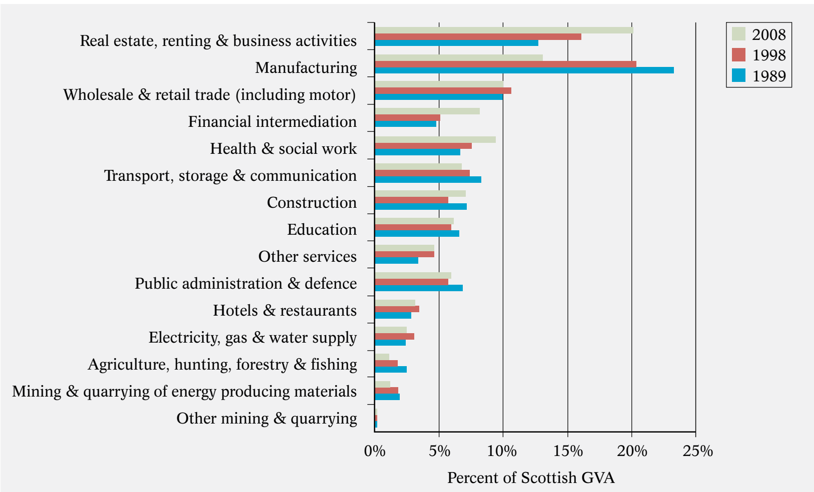
1.) a set of assets in the form of physical and human capital,
2.) a business environment that is attuned to an existing set of behaviours and trading relationships

In this chapter, I investigate how these assets and behaviours might be changed to improve the chances of achieving sustainable long-term growth. I begin by examining where the Scottish economy has been going in recent decades. In particular, I look at the decline in manufacturing in Scotland and consider whether it could and should be reversed.

TRENDS IN THE SCOTTISH ECONOMY

The Scottish economy has changed substantially in the last few decades. This is illustrated in Figure 2 which breaks down the output (Gross Value Added) of the Scottish economy by industry sectors for the years 1989, 1998 and 2008. This covers the time span for which consistent data is available from the Office for National Statistics.

FIGURE 2: GROSS VALUE ADDED BY INDUSTRY SECTOR, 1989, 1998, AND 2008



SOURCE
Office for National Statistics

Between 1989 and 2008, the contribution of manufacturing to Scotland's economic output more than halved. It dropped from 24% to 11.9%. In contrast, the contribution of real estate, renting and business services increased substantially. More modest gains were made in finance and banking and health and social work.

The performance of Scottish manufactured exports has been particularly troubling. Between 1998 and 2008, manufactured exports from Scotland had fallen by around 17 per cent (by 2010, they had fallen by 25 per cent) (Source: Scottish Index of Manufactured Exports). This contrasted with the UK as a whole, though its performance was poor compared with other developed countries and China in particular -

In the decade from 1998-2008, the UK increased its exports of goods by 72%, to 468 billion USD. The rates of increase have been stronger in other developed countries like USA (95%), Germany (176%), France (100%) or Japan (100%). However, all these developed economies have lost market share in goods exports to emerging and developing countries. A main contribution to this trend has been China whose goods exports have increased 682% since 1998, to 9.5% of world exports in 2009. BIS/DFID (2010)[52]

The data on exports suggest that the relative contribution of the "tradeable" sector in the Scottish economy has fallen sharply over this period. This means that the focus of production in Scotland has changed from markets outside Scotland and instead been increasingly directed towards domestic consumption. For an independent Scotland, unless it had substantial overseas investments, this would not be a feasible position to sustain in the long run if it continued to consume a high level of imports. The resulting balance of trade deficit would have to be dealt with through restoring international competitiveness - meaning lower wage costs in a fixed currency regime or depreciation in a floating currency structure. In 2007, Scotland exported £34 billion to the rest of the UK and £19 billion to the rest of the world. It imported £44.2 billion from the rest of the UK and £21.5 billion from the rest of the world. This left it with a deficit on the current account of £12.6 billion, around 12.5% of Gross Value Added[53]. Among OECD countries, relatively few have such a high current account deficit. In 2007 only Estonia, Greece and Iceland had current account deficits that exceeded 12.5%. The overall UK current account deficit in 2007 was 2%[54].

52 Department for Business Innovation and Skills/Department for International Development (2010) UK Trade Performance Over the Last Ten Years

53 Source: Scottish Government Input-Output Tables 2007 [accessed at: http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/Input-Output]

54 Source: OECD Main Economic Indicators

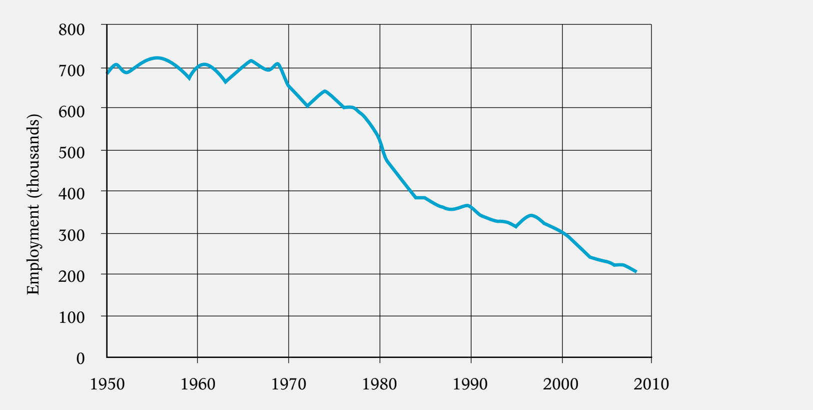
Part of the explanation for the decline in manufacturing is globalisation: Scottish manufacturers find it difficult to compete with low-cost producers in Asia and Eastern Europe. Some of the main declines in Scotland's export markets were in traditional manufacturing industries, such as steelmaking and shipbuilding. In addition, some industries that were new to Scotland, such as electronics and electrical engineering, expanded rapidly and then suffered significant decline. Again, the main culprit was competition from abroad.

The decline of manufacturing had significant social implications. Some parts of Scotland such as Inverclyde, North Lanarkshire and Dundee have had great difficulty in replacing manufacturing-based employment, resulting in pockets of long-term unemployment and social deprivation. This has been a concern of policy makers ever since, with many attempts at economic regeneration, most of which have failed. The Scottish Trades Union Congress believes that, at a minimum, government strategy should now be aimed at safeguarding manufacturing employment levels at their current value of around 225,000 people[55].

Given past trends, it seems that this would be a difficult task. Employment in Scottish manufacturing has declined massively since the middle of the last century. Figure 3 shows that Scottish manufacturing employment in 2008 was less than a third of its 1950 value. There was a particularly rapid decline in the 1980s, when many of Scotland's heavy industries vanished. In the first half of the 1990s there was some recovery, partly as a result of the rapid growth in electrical engineering and electronics - the so-called "Silicon Glen" phenomenon. Most of the employment in electronics was low skill assembly work that was susceptible to lower cost competition from the developing economies of Eastern Europe and Asia. Many of the multinational companies that established assembly plants in Scotland at the beginning of the IT boom subsequently left.

55 Scottish Trades Union Congress (2007), 'The Future of Manufacturing Industry in Scotland', [accessed at: http://www.stuc.org.uk/policy/economic-industrial-policy/discussion-papers-series/the-future-of-manufacturing-industry-in-scotland]

FIGURE 3: EMPLOYMENT IN SCOTTISH MANUFACTURING 1950-2008



SOURCE
Annual Business Inquiry, Scottish Register of Employment

Within manufacturing, there has been widespread variation in the rate of employment decline. Table 4 shows data on employment within manufacturing for the period 1995 to 2008[56]. Jobs in textiles, refined petroleum products and metals all fell by over 50% between 1995 and 2008. Employment in office machinery and computers and radio, television and communication equipment declined by more than 70% over this 13 year period. Across all of manufacturing, with the exception of the new industry "recycling", there were significant falls in employment.

The two main causes of the decline in the number of manufacturing jobs were loss of competitiveness to producers elsewhere and increases in productivity. While manufacturing output as a whole increased by 3.1% between 1995 and 2008[57], manufacturing employment fell by 34% over this period. The rapid improvement in productivity meant that a modest increase in output was consistent with a fall in employment of over a third. The fact that manufacturing output in Scotland did not increase by nearly as much as the growth in manufacturing production worldwide was due to a loss of competitiveness to foreign producers. Our costs, particularly wage costs, are

56 These data are derived from the Annual Employment Survey 1995 to 1997, and the Annual Business Inquiry thereafter. The changes in employment have been calculated within each dataset. Thus the change for those years between which the data collection method changed has been ignored, which may result in an underestimate of the total decline in employment over the period.

57 Unfortunately, due to the recession, by 2010 Scottish manufacturing output had fallen back to 4.2% below its 1995 level.

too high, our technology is not good enough, our business environment is deemed less attractive than elsewhere or Scottish goods are denied access to foreign markets. These would be key issues for any Scottish government with additional fiscal and economic powers that hoped to improve levels of income across Scotland.

Trends in employment within manufacturing have not been uniform. While there was a small increase in overall manufacturing output between 1995 and 2008, there were some massive declines in particular industries. Thus, for example, between 1998[58] and 2010 output of electrical and instrument engineering fell by 44% and paper printing and publishing by 32%. In these areas in particular, cheap competition from abroad cut into Scotland's market share.

But, over the last two decades, total employment in Scotland has grown significantly, notwithstanding the decline in manufacturing. Between 1995 and the start of 2011, employment (including self-employment) grew from 2.48 million to 2.70 million. Clearly, there was significant growth outside manufacturing. Using data from the Labour Force Survey, we can track how employment evolved in different sectors. This is shown in Table 5.

58 There are no data for the components of Scottish manufacturing before 1998

TABLE 4: CHANGE IN SCOTTISH MANUFACTURING EMPLOYMENT 1995-2008

	Change in employment 1995-2008 (000s)	Change in employment 1995-2008 (%)	Employment in 2008 (000s)
Food and beverages	-12.3	-21%	44.2
Textiles	-11.2	-53%	7.1
Wearing apparel; dressing and dyeing of fur	-12.5	-83%	1.9
Leather goods	-0.8	-53%	0.6
Wood and products of wood and cork, except furniture	-1.2	-13%	8.7
Pulp, paper and paper products	-2.3	-24%	5.9
Publishing, printing and reproduction of recorded media	-7	-35%	14
Coke, refined petroleum products and nuclear fuel	-1.1	-58%	1.9
Chemicals and chemical products	-4.2	-29%	12.1
Rubber and plastic products	-0.3	-2%	11.1
Other non-metallic mineral products	-3.9	-41%	6.3
Basic metals	-2.9	-57%	2.3
Fabricated metal products, except machinery and equipment	-3	-11%	24.3
Machinery and equipment not elsewhere classified	-10.6	-35%	19.2
Office machinery and computers	-6.3	-79%	3.4
Electrical machinery and apparatus not elsewhere classified	-6.2	-47%	6.1
Radio, television and communication equipment and apparatus	-11.6	-72%	6.3
Medical, precision and optical instruments, watches and clocks	-2.2	-18%	10.7
Motor vehicles, trailers	-1.1	-24%	3.9
Transport equipment	-6.3	-33%	12.9
Furniture; manufacturing not elsewhere classified	-2.6	-35%	6.1
Recycling	0.3		1.4
Total Manufacturing	-109.3	-34%	210.5

SOURCE

Annual Employment Survey, Annual Business Inquiry

TABLE 5: EMPLOYMENT IN SCOTLAND IN 1995 AND 2008 BY SECTOR

	Employment (thousands)		
	1995	2008	Change
Agriculture and Fishing	61.9	47.6	-14.2
Mining, Oil and Gas	35.0	54.0	19.0
Food & Drink	58.4	43.3	-15.1
Textiles	43.5	7.3	-36.2
Wood, Paper, Publishing and Printing	47.7	28.1	-19.7
Refining and Chemicals	23.5	17.8	-5.7
Rubber, Plastics and Minerals	29.3	18.0	-11.4
Metal Fabrication and Mechanical Engineering	65.2	62.7	-2.5
Office Machinery, Electrical and Electronics	69.6	34.3	-35.2
Motor Vehicles and Ships	25.7	27.0	1.3
Other Manufacturing	4.9	8.9	4.0
Electricity, Gas and Water	23.2	33.3	10.1
Construction	167.8	216.1	48.3
Motor Vehicles, Repairs	42.6	39.0	-3.7
Retail and Wholesale	277.6	286.0	8.4
Hotels, Restaurants and Household Goods	123.1	139.9	16.8
Transport	139.1	147.0	7.9
Banking and Finance	127.8	144.3	16.5
IT Consultancy and Processing	10.4	29.1	18.7
Research, Auditing, Advertising and Recruitment	84.9	126.9	42.0
Miscellaneous Business Activities	35.4	50.8	-15.4
Administration, Defence and Social Security	154.8	196.0	41.1
Education	168.2	212.5	44.3
Health and Social Work	286.9	382.0	95.1
Business and Professional Organisations	20.2	15.0	-5.1
Creative Industries	69.3	80.0	10.7
Other Service Activities	59.7	52.0	-7.7
Total	2267.5	2480.5	212.9

SOURCE

Labour Force Survey[59]

59 This data sources differs from the Annual Business Inquiry. I have used my own aggregation from the two digit classification to be able to draw conclusions about industrial groupings that are frequently commented upon. Note also that the figures for the public sector are somewhat larger than those published using different sources by the Scottish Government.

What is striking from this table is that 85% of the growth of 212.9 thousand jobs in Scotland between 1995 and 2008 can be attributed to three sectors - Health and Social Work, Education and Administration, Defence and Social Security. Most of these jobs are in the public sector. If such jobs are debt-financed, whether the debt is incurred in London or Edinburgh, this is clearly not a sustainable long-run growth path for the Scottish economy. The difficulty is that the recent changes in industrial structure and employment described above have become embedded in the Scottish labour market and will have to overcome some formidable barriers if they are to be reversed.

Take, for example, what has happened to Scotland's occupational structure in recent years. Changes in industry naturally bring about changes in the occupational makeup of the Scottish workforce. Table 6 brings together the main occupational "winners" and "losers" between 2002 and 2010[60]. Specifically it lists the 12 occupations that have experienced the greatest decline in employment in Scotland between 2002 and 2010 and the 12 occupations where the employment gain has been largest. Thus in Table 6, the second column shows the level of employment in Scotland in 2002; the third column shows employment in 2010; the fourth column shows the change in employment over this period and the final column shows the average wage in that occupation in 2002. Due to sample size some of these average wages have large associated standard errors.

The changes in employment reflect our earlier discussion of changes in the structure of Scottish industry. The losers are dominated by occupations based in industries where output has been falling or reflect tasks that can now be performed by IT controlled equipment. Thus, jobs that involve working with metal figure highly among the losers. Industries using metals have declined and the ability of machinery to substitute for labour in performing tasks with metals has increased. Similarly, information technology has had a marked effect on those occupations that involve routine manual or administrative operations which are prominent amongst the losers.

The winners reflect the growing prominence of different forms of care - health care, social care etc. - in Scottish employment, as mentioned previously. The fast growing occupations are also biased towards professional and managerial jobs. These occupations are relatively highly paid. But some of the occupations whose growth has been most rapid offer wages that are well below the Scottish average. The conventional wisdom has been that to compete in the modern world, the Scottish economy

60 While the choice of years for this comparison does not cover the span that has previously been considered, it covers the longest recent period for which one occupational classification is available. Changes between occupational classifications are fraught with difficulty.

should focus on high-end skills that pay well above the average. So why should we find that some growth has concentrated at the low end of the skills spectrum? We return to this issue in the next section.

Taking the evidence together, it is clear that the Scottish economy has gone through significant structural change in recent decades. This has partly been due to a loss of comparative advantage in the production of tradeables. As a consequence, production has become increasingly focused on the domestic market. Employment in manufacturing has fallen sharply, partly due to a loss of market share and partly due to improvements in productivity. This means that many of the skills associated with tradeables production in Scotland have been lost. In contrast, employment in sectors that are largely focused on domestic production has grown. New skills have been accumulated which are relevant to the existing structure of demand. These have a greater focus on domestic production than was previously the case. Skills providers have adjusted their education and training provision to meet these new demands. In a world of bounded rationality, they react to the incentives immediately before them.

TABLE 6: CHANGES IN EMPLOYMENT 2002-2010

	Employment (000s)		Change (000s)	Average Wage
Losers	2002	2010		2002
administrative: government & related	69.2	55.3	-14.0	£291.5
assemblers and routine operatives	30.0	18.6	-11.4	£233.7
administrative occupations: finance	70.5	60.0	-10.5	£222.3
process operatives	35.5	25.7	-9.8	£247.3
metal machining, fitting, instrument making	36.2	27.0	-9.2	£391.7
leisure & travel service occupation	20.1	11.3	-8.8	£256.2
sales related occupations	15.1	8.1	-7.0	£219.9
elementary cleaning occupations	79.3	73.2	-6.1	£111.3
elementary agricultural occupations	16.0	11.5	-4.5	£126.7
transport drivers and operatives	90.9	86.5	-4.3	£299.5
printing trades	7.0	2.7	-4.3	£382.0
metal forming, welding and related	15.3	11.6	-3.7	£305.5
Winners				
corporate managers & senior officials	6.3	16.0	9.7	£849.0
social welfare assoc professionals	19.6	30.3	10.7	£269.0
public service and other assoc professionals	25.4	37.5	12.0	£329.2
customer service occupations	34.7	46.9	12.3	£238.7
financial institutions and office manager	24.9	37.5	12.5	£534.9
agricultural trades	23.3	36.7	13.4	£234.0
elementary personal service occupations	85.2	98.6	13.4	£104.7
functional managers	65.2	79.9	14.8	£724.4
production managers	41.4	56.5	15.1	£600.8
health associate professionals	58.3	79.7	21.5	£358.5
childcare & related personal services	34.9	60.2	25.3	£160.7
healthcare & related personal service	93.2	122.8	29.6	£200.0

Much of the recent increase in employment is dependent on public spending. Given the UK current sovereign debt crisis and the focus on restoring fiscal probity, it is unlikely that domestic demand will be a significant source of jobs growth in the foreseeable future. The same difficulties would broadly confront a newly independent Scottish government, though the precise circumstances would depend on the share of the UK national debt that Scotland takes over and the allocation of tax revenues to Scotland. However, an independent Scottish government would have the added issue of the current account deficit to consider.

ANALYSIS

The question of where the new jobs might come from is exercising many governments that have witnessed a decrease in employment and increasing unemployment as a result of the recession. The decline in manufacturing employment has not been consistent across countries. Figure 4 shows changes in manufacturing employment in OECD countries over the period 2000-2010.

FIGURE 4: CHANGE IN MANUFACTURING EMPLOYMENT 2000-2010

SOURCE
OECD

The fall in manufacturing employment in the United Kingdom is only exceeded by that in Luxembourg. The manufacturing employment decline in the USA is close behind that in the UK as, somewhat surprisingly, is Ireland. The fall in the USA has occurred even though the USA can still justly claim to be the centre of technical innovation.

Manufacturing employment in countries such as Switzerland, Italy and Germany has fallen much less rapidly than in the UK even though their wage costs are as high or higher than the UK and their corporation tax rates are close to, or above, the UK rate. The differences in performance may be due to the ability of these countries to identify and exploit niche markets in manufacturing to a much greater extent than the UK. One might speculate that this outcome may also be linked with differences in the capital structure of manufacturing firms in these countries.

The decline in manufacturing employment in Scotland has been even more rapid than in the UK as a whole. In 2010, Scotland only accounted for 6.6 per cent of UK manufacturing employment, well below its population share of 8.8 per cent. This suggests that Scotland is at the extreme high end of the distribution of falls in manufacturing employment in recent decades. This would be acceptable if there were sustainable alternative employment opportunities. But in this instance, "sustainable" means being consistent with fiscal balance in the long run. As we have seen, this does not appear to be the case. So where will new jobs be generated in Scotland?

While it might be nice to imagine a swift return to historic levels of manufacturing employment (or tradeable production which also encompasses tradeable services), this will not happen. The STUC objective of maintaining existing levels of manufacturing employment is more realistic, but may be difficult to achieve.

The discussion in the US focuses around the "jobless" recovery. Innovation of itself does not guarantee the expansion of employment, particularly when multinational companies are now accustomed to establishing successful globalised supply chains. Thus, though the US may generate many of the innovations on which the latest production trends are based, this does not guarantee high levels of manufacturing employment in the USA. While wage costs are lower elsewhere, multinationals will farm out stages of production to these locations. This is also known as "offshoring". It also affects services including customer support where it can be achieved through the use of call centres. Inevitably, this means that UK or Scottish call centres are competing with alternative provision in much lower cost parts of the world.

Another aspect of the evolution of the US jobs market focuses on the changing demand for skills. Autor (2010)[61] highlights two aspects of this. First, the American education system is no longer able to keep up with the increasing demand for skilled workers. There has been a slowdown in educational attainment, particularly for males. Second, there has been an increasing polarisation of job opportunities in the US Labour market. The jobs market has become increasingly polarised. There is increasing demand for high skilled professional, technical and managerial workers. But there is also an increase in demand for low skilled workers that perform personalised services. The provision of personal services cannot be competed away by low-cost foreign producers, because they are not on hand to provide the service. Thus, job opportunities for care workers and those working in customer services, for example, have been increasing.

But jobs in the middle of the skills range are much less common than they used to be, partly as a result of the decline in the demand for manufacturing operatives. In addition, the supply of clerical, sales and administrative jobs has declined sharply. This has had particularly negative effects on male employment, resulting in them being concentrated in low-paying service jobs.

But these arguments are consistent with the Scottish findings in Table 6. The jobs that have been lost in Scotland over the last 10 years have been concentrated in middle-skill occupations. Those that have been gained are either at the high-end or the low-end of the skills distribution. Such changes are shared not just with the US, but also with most European countries. Of course, this process leads to increased income inequality.

So what are potential policy responses? First, it should be recognised that public sector organisations which might be expected to help with the reskilling of the Scottish workforce are not expected to take a global perspective. Instead, they respond to the incentives that confront them. If they are given money to train workers for a career in mining then they will do so irrespective of whether employment opportunities exist in this industry. Therefore, if the Scottish government cannot design these incentives properly, it will reinforce, rather than offset, the negative employment trends that have been catalogued in this paper.

Second, Scottish manufacturing seems to be retrenching to sectors in which it has a comparative advantage such as food and drink in which it is protected partly by the perishability of food and partly by branding protection in the case of whisky. These products are not characterised by rapid innovation. While innovation may not be a sufficient condition for a

61 Autor, D. (2010) 'The Polarization of Job Opportunities in the U.S. Labour Market: the Implications for Employment and Earnings', The Center for American Progress and The Hamilton Project, April

high wage economy such as Scotland to expand its areas of comparative advantage, it is certainly necessary. Innovation does not occur without effective spending on research and development. The UK does not spend a large amount on R&D compared with many industrialised countries. Thus, for example, in 2006, OECD data suggest that the UK spent just over 1% of its gross domestic product on research and development. This compares with 2.7% in Sweden, 2.5% in Finland, 1.7% in Denmark and 1.8% in Germany. Ireland spends less than the UK, only 0.8% of its GDP on R&D. But within the UK, Scottish spending on R&D only accounted for 0.47% of its GDP. This contrasts with the 3.6% of GDP spent on R&D in the Eastern region of England and is substantially less than most other European regions. Scotland is also at the bottom of the league of business R&D spend among provinces/regions that aspire to greater autonomy. The Basque country spends around 1.3% of GDP, while in Quebec 1.5% of the province's output goes to developing new products. Without the research and development, new products are not developed and without new products, trade suffers and exports decline.

It is undeniable that Scotland's record of business spending on research and development is extremely poor and it is difficult to see how it can extend the range of its comparative advantage unless this record improves. The public sector may be able to help with this. Greater specialisation among higher education institutions might assist. Having a small number of technical universities might be advantageous compared with allowing institutions to try to achieve excellence across the board. And if Scotland gained control of corporation tax, then more generous R&D allowances might have a bigger payoff than simply introducing a lower corporation tax rate.

Lack of effective research and development may contribute to Scotland's poor business birth rate. Table 7 below shows Scotland's share of births, deaths and the stock of private UK businesses from 2004 to 2009. Scotland accounts for 8.8 per cent of the UK human population, but only 6.4 per cent of the businesses. Births and deaths are approximately equal, which is consistent with the finding that Scotland's share of the stock of UK businesses is fairly constant, but substantially below its human population share. What this means is that start-ups are much less frequent than would be expected given Scotland's population size, but once started, businesses tend to last for about as long as they do in the rest of the UK. It is getting them started that is the real problem.

TABLE 7: BIRTHS AND DEATHS OF FIRMS: SCOTLAND AS A SHARE OF UK

	2004	2005	2006	2007	2008	2009
Births	5.1%	6.2%	5.9%	6.5%	6.1%	6.2%
Deaths	6.0%	6.0%	6.1%	5.4%	5.9%	5.5%
Stock	6.3%	6.3%	6.3%	6.3%	6.4%	6.4%

SOURCE
Office for National Statistics (2009), "Business Demography"

The contrast in business environments with other parts of Europe is even more marked. Table 8 shows the number of enterprises and manufacturing enterprises per 1000 population in different parts of Europe. This table tells a mixed story. Surprisingly, Germany has a very low number of enterprises and manufacturing enterprises per 1000 population. This certainly reflects the low rate of business formation in the old East Germany. It may also be indicative of greater scale in German businesses. Along with Germany, Ireland has a lower number of enterprises per 1000 population than Scotland. This disparity carries over to the manufacturing sector, where Scotland has more enterprises per 1000 population than Ireland. Some aspire that Scotland join the social democracies of Scandinavia, citing their widespread provision of non means-tested welfare benefits. What is not often realised is that these welfare benefits are supported by a business environment that is supported by a very strong small business culture. Thus, all of the Scandinavian countries have substantially more enterprises per 1000 population than Scotland both in manufacturing and in the economy at large.[62]

62 There are no data on the manufacturing sector in Norway

TABLE 8: NUMBER OF ENTERPRISES, HUMAN POPULATION AND ENTERPRISES PER 1000 POPULATION: 2008

	Businesses per 1000 population	Manufacturing Businesses per 1000 population
Germany	11.5	0.5
Ireland	22.6	1.2
South Western Scotland	23.0	1.6
Eastern Scotland	26.4	1.6
Scotland	26.5	1.8
Highlands and Islands	30.6	2.2
North Eastern Scotland	41.0	3.0
France	41.1	3.6
Denmark	43.4	3.4
Norway	57.1	n/a
Finland	61.2	4.6
Sweden	67.3	6.2
País Vasco	69.4	5.8
Cataluña	75.6	6.0

SOURCE
Eurostat

Thus, Scotland had 26.5 enterprises per 1000 population in 2008. Denmark, Norway, Sweden and Finland had 43.4, 57.1, 67.3 and 61.2 respectively. Thus, compared with Scotland, all of the Scandinavian countries had significantly more enterprises per head. And in Spain, the Basque Country (Pais Vasco) and Catalonia also have a much larger population of enterprises and manufacturing enterprises than Scotland.

There are some puzzles with these data: the results are certainly more equivocal than those on business research and development spending. Germany is Europe's most successful manufacturing nation and Ireland has trumpeted the success of its inward investors in energising the Irish economy. These factors are not evident from the statistics on enterprises per head of population and may, as mentioned earlier, reflect greater scale in the average enterprise in Germany and Ireland. The differences with the Scandinavian countries and with the semi-autonomous provinces of Spain is also quite stark, but in the opposite direction. Perhaps no clear conclusion can be reached, but it is worth noting that out of the 349 areas of Europe listed by Eurostat in this table, Scotland comes 267th in number of enterprises per 1000 population. This suggests that, at least in this broader picture, Scotland has many fewer enterprises than one would expect in the "average" European region.

Is it desirable to reverse the enterprise gap and the decline in Scottish manufacturing? The danger in not doing so is that Scotland slips into independence with a dangerously unbalanced economy. The decline in the manufacturing sector has gone further and faster than almost anywhere else in Europe. The decline of the last two decades has perhaps been the unintended consequence of a belief that allowing economic activity to focus on financial services in the South-East of England would not have adverse effects on the economy of other parts of the UK. With some notable and unfortunate exceptions, other European countries have been less willing to allow their economies to be dominated by financial services and adopted tighter regulation or other measures to keep its growth in check.

So it is certainly a reasonable aspiration to restore some of the lost ground in the production sector in Scotland. It is desirable for social reasons – particularly for the young unemployed. It is also desirable for reasons of resilience – spreading the economic base makes it less susceptible to external shocks. It is also desirable on environmental grounds – manufacturing in Scotland is almost certainly less polluting than having the same goods produced in Asia. And finally, and perhaps most importantly, it may be the best route to restore economic growth given that it will be focussed on producing tradeable goods at a time when growth in domestic demand is likely to be constrained possibly into the long-run.

Nevertheless, the changes to the structure of employment in Scotland, including the decline of manufacturing have set in train a chain of events that make it very difficult to achieve a rapid reversal in its fortunes. The low levels of business R&D spending in Scotland may reflect the decline of manufacturing as well as being part of its cause. But this should not be used as an excuse not to develop policy to increase private sector investment in innovation.

The type of jobs that have replaced those in manufacturing are heavily dependent on the public sector and may not be sustainable in the long run. The changing structure of jobs and the polarisation of the labour market pose further difficult questions for the Scottish government. But developing a radical approach to skills formation is now essential if a long-run solution to the decline in Scotland's comparative advantage is to be found. Only when these skills are available will it be possible to increase Scotland's output of niche manufactured goods in which it has a real comparative advantage.

CHAPTER 7
OPTIMAL MONETARY ARRANGEMENTS FOR SCOTLAND: ADOPT WHICH MONEY AND WHY?

BY PROFESSOR ANDREW HUGHES HALLETT

INTRODUCTION

The alternative monetary arrangements open to the Scottish economy are membership of a currency union (the existing UK union, or the Eurozone); a currency peg to an outside currency; or complete monetary independence. Each would imply a certain choice of monetary policy, and hence interest rates and credit conditions, although only the last requires us to set targets, priorities and rules for the conduct of that policy. However, as has become only too clear in Europe, as in the UK, in the recent crisis, the choice of suitable monetary arrangements cannot be made without specifying the fiscal regime at the same time.

In this paper, we consider only independent monetary policies or currency unions with a degree of fiscal autonomy, since it makes little sense to choose any monetary regime in which fiscal policies are tied. If that were chosen, monetary policies would have little consistency or credibility as a stabilisation instrument, and would inevitably destabilise the exchange rate, trade and capital flows. This paper is therefore a review of the monetary side of the home rule proposal. For a longer discussion of the fiscal side, that is the tax and spending possibilities, see Hughes Hallett and Scot (2010).

FISCAL AUTONOMY WITHOUT POLITICAL OR MONETARY INDEPENDENCE

The first regime to consider is fiscal autonomy without political independence. This is the regime in which the Scottish Parliament would have full control over its own fiscal affairs (taxes, spending and borrowing), but accepts that monetary control covering interest rates, credit conditions, exchange rate arrangements, banking supervision and regulation (including any bail out arrangements) is best exercised by the Bank of England and the UK government.

In this case, all fiscal functions would be allocated to the Scottish government, to give the government complete control over the raising and collecting of taxes, and how and where they are spent – including the setting of tax/expenditure rates, bands, the tax base, and extending the government's remit to include inheritance tax, corporation tax, other business taxes, excise taxes, carbon and natural resource taxes and the like. There would be little remaining dependence on the UK central budget; and hence only small inter-regional transfers, and limited risk sharing with the rest of the UK[63], except in so far as the Scottish government found it convenient to subcontract certain activities (such as defence and security, foreign relations, financial oversight, competition policy, monetary and exchange rate policy, or state run pensions) to London. This is to divide the available policy instruments between jurisdictions according to comparative advantage; that is, between those with the largest direct impact locally and those which provide the economic framework within which everyone has to work. There would also be no central government guarantees on any debt the Scottish government might issue (unless the London government found it convenient to offer bail-out facilities rather than suffer the financial fallout from a default in Edinburgh). And Scotland might have to accept risk premia on her interest rates in bad times, or if her debt/deficit management proved to be weak.

There are two obvious ways in which this kind of devolution could be reached with monetary arrangements being controlled from outside. They differ, not so much in their structure, but in the operational constraints that policymakers would have to face from other parts of the economy or from the currency zone itself.

i. The first is where Scotland achieves f*ull fiscal autonomy within the United Kingdom:* that is, fiscal independence within the UK economic and political union. Examples of such arrangements are well developed within advanced economies. This shows it to be feasible and sustainable as a regime. The Channel Islands and Isle of Man already have such a status within the UK (as did Scotland in the 17th century). The Basque and Navarra regions in Spain, and South Tirol in Italy, also enjoy

63 There would still be risk sharing via integrated capital or financial markets, and via loans/credit channels, however. Studies have shown that these channels typically supply the larger part of risk sharing within a currency union: 80% in the case of US or Canada, and roughly half that within the UK. But those channels typically supply a good deal less risk sharing outside a currency union [Asdrubaldi et al, 1996, Kalemli et al 2003, Melitz 2004].

such an arrangement with the twist that they pay fees to their central government for common services (thereby eliminating any possibility of a conflict with EU rules on state aid). Further examples which approximate this model are, in descending order of approximation, the cantons in Switzerland; Hong Kong in China; the provinces of Canada; and the US state governments.

ii. The second possibility is that Scotland achieves *full fiscal autonomy as an independent member of the Eurozone*; that is, fiscal and political independence within a European economic and currency union. Obvious parallels can now be made with the existing members of the Euro area, some of which have prospered within that union, and some of whom clearly have not.

There are also obvious differences between those two regimes. Scotland could in principle face quite different constraints on her freedom of action depending on whether she remained in the UK economic union, or joined the Eurozone (the European monetary union). One concrete example is that, in the Eurozone, Scotland would be subject to the Stability and Growth Pact's constraints on fiscal policy – which, in the latest proposals, would effectively limit the Scottish government to running a nearly balanced budget at all times and observe a maximum debt ratio on the penalty of significant fines. It is not clear what constraints on fiscal policy might be imposed by the UK government if a fiscally autonomous Scotland were to stay in the UK economic union. It is unlikely that there would be none, but they are unlikely to be the same or as restrictive as those imposed in the Eurozone – although the fiscal constraints proposed in the new Scotland Bill are very restrictive.

Similarly, just as a result of different trade and investor relationships, the trade and capital inflow or outflow pressures would be quite different – which implies in turn that Scotland would experience quite different exchange rate pressures. Finally, as far as monetary policy itself (interest rates, credit conditions) is concerned, Scotland would get an independent voice, albeit small, in the setting of those policies in the Eurozone by virtue of being a member of the ECB. That would not be the case in the UK economic union, unless the Bank of England changed the rules and appointed a Scottish representative to their monetary policy committee.

iii. There is a third possibility. That is a *fully independent Scotland outside any currency area*, like Switzerland or Norway today.

This last possibility may seem a relatively unlikely scenario from the political point of view. But it involves many of the same institutional, financial and non-fiscal economic choices that an independent Scotland within Europe would face. So for the purposes of discussion, we can start by focussing on the first two options and then treat an economic and monetarily independent Scotland as a variation of the second.

ADVANTAGES OF FISCAL AUTONOMY WITHIN THE UK CURRENCY UNION

In this regime, all taxes and spending come under Scottish control. So there are very few changes to the current regime except as a matter of degree. The four substantive changes are:

- There will be fewer direct transfers between regions or redistribution from the centre, except those built in as a matter of choice, since there is a reduced central budget. Risk sharing, insurance against bad times and support for investment or development on a needs basis will be less therefore. The new Scotland Bill is already moving in that direction, if only by a small amount.

- Instead Scotland will be able to choose her own stabilisation policies to suit her own circumstances and timing. Hence, the discretionary decisions, accountability and need for fiscal discipline now rest with the Scottish government. That raises the question of whether new institutions are needed to reinforce that discipline and manage Scottish public debt.

- Fiscally independent countries in a monetary union have typically found that they need to use their fiscal policies more aggressively, and with larger interventions[64], to achieve the same level of performance as others because they lack the additional instruments of monetary policy or an exchange rate to help out. This must be especially true for small economies because they are too small to influence the union-wide monetary policy in their favour; and additionally so in our case given the absence of any risk sharing transfers. That raises the prospect of additional deficits, and that larger policy changes may be necessary.

- Again the need to reinforce fiscal discipline appears to be key, as is the possibility that the more aggressive fiscal policies will work against the common monetary policy. Debt targets have been suggested as a coherent way to anchor discipline, to reduce those conflicts and moderate the swings in policy, without sacrificing internal consistency (Hughes Hallett 2008a,b).

One issue that has to be resolved, in this regime, is a settlement on the oil and gas revenues; and any joint expenditures for shared services like defence,

64 This is a frequent observation: see Hughes Hallett et al (2004), Hughes Hallett and Lewis (2008).

foreign policy and representation, state pensions or debt service. However, official figures show the Scottish fiscal budget would be in mild surplus with a geographical share of oil and gas revenues.[65] So, as things stand, to reach such a settlement would be entirely feasible from an economic point of view, even if not politically.

Four other advantages in this regime stand out as matters of degree.

i. As a settlement it would certainly be fairer than the other regimes since everything that is spent would be raised in Scotland, and be the result of decisions made by the Scots themselves. That essentially resolves the equity issue, and should broaden the political support for this as a regime on both sides of the border.

ii. Second, having to raise all their own taxes should increase the level of fiscal responsibility among policymakers. They would therefore be responsible for creating a better economic performance, and would have the levers to do so.

iii. Third, greater fiscal responsibility means the incentives will be more closely aligned to the needs of the economy. The result would be greater efficiency in the decisions and fewer distortions. No conflicts with EU rules are implied since, even if Scottish tax rates deviate from the UK average, there are no equalisation payments of any kind being made. It also creates the possibility that lower taxes, and hence lower costs, would be used to boost competitiveness – and hence employment.

iv. Finally, the fact that an oil and gas settlement would now have to be reached, it becomes possible to think about setting up a Sovereign Wealth Fund for long term investment and stabilisation – perhaps on the Norwegian model.

AN INDEPENDENT SCOTLAND WITHIN THE EUROZONE

On the face of it, this regime appears to be identical to the last one except with a different partner. So the implications should be the same. But there is a crucial difference: to get into this regime, Scotland would have to achieve political as well as fiscal independence – where the previous regime required only fiscal independence.

To be clear, we do not consider the case of Scotland in the European Union but not in the Euro. There are two reasons. First, all new members of

65 Until 2009: see Government Expenditures and Revenues Scotland, The Scottish Government, HMSO.

the EU are required to join the Euro eventually and it is not clear that there are grounds to argue that Scotland has the right to inherit the UK's current Euro opt out. And she might well prefer to join anyway. Second, if Scotland had an opt out, then she would be an independent economy like the UK or Sweden - even as a member of the EU. We deal with that case separately below.

Under political independence, fiscal policy would be set as in fiscal autonomy above and its implications would be essentially similar, but without any choice for even a limited degree of risk sharing. Moreover, constraints would be imposed on Scottish deficits and debt as part of the Stability Pact.[66] Under the revisions being considered for the Stability Pact, these constraints are likely to constrain fiscal policies to a large extent. Since, under a currency union, the loss of an independent monetary policy and exchange rate makes fiscal policy more important for stabilising growth and employment, more variable income levels are likely to follow and effective debt management would become more important. But this is only to accentuate the effects of being in the UK currency union.

Given that, the other major issues that need to be resolved are: the oil and gas settlement; the transition process (how to split up the assets and liabilities of the UK); and then how to design monetary policy during that transition; how to create a new central bank, monetary institutions and financial oversight; the effect of the Euro exchange rate on the Scottish economy; and what needs to be done to function as a member of the Euro (a separate social chapter, new competition policies, and new EU budget arrangements). Finally, there is the question of relations with, and representation at, the major institutions (UN, IMF, World Bank, BIS, WTO, OECD, European Commission etc) and whether new double taxation agreements need to be devised (a change in tax authority could alter the tax credits received at home by non-UK firms and hence increase or decrease their willingness to expand or stay in Scotland).

To be accepted into the Euro also requires accepting some permanent changes in the way the economy is run. Inflation and monetary policy would be controlled by the European Central Bank, with the active participation of a new and independent Reserve Bank of Scotland. The ECB has a reputation for following more restrictive policies than the Bank of England, although in practice this has translated into less activist policies rather than lower inflation or higher interest rates. That has led to a higher degree of income volatility in the Eurozone and overextended fiscal policies to smooth those volatilities out. There is however no possibility of the national interest being

66Currently, the Stability Pact requires all members to limit their net fiscal spending to less than 3% of national income at all times (and zero on average), and public debt to less than 60% of national income.

represented at ECB decision making; nor of Scottish conditions influencing those decisions (the Scottish economy is too small). Euro entry also requires Scottish inflation to be brought to within 1.5% points of the average of the lowest three in the Eurozone. After that, monetary policy is set to meet the needs of the Euro-average and any specific national needs have to be met by adjusting national fiscal policies as far as is practical. That means using more flexible and more activist fiscal policies than has been possible in the past. That has also been necessary in the UK monetary union, except that the possibility of making the additional fiscal policy adjustments has always been denied. That is why it is necessary to break out of the existing system. Similarly, Scotland would have to accept interest rates determined in the financial markets of Europe rather than London – although in an age of globalised finance, this is not going to make much difference.

Scotland would also have to live with the Euro instead of a Pound exchange rate. This might prove to be a challenge for an economy whose trade, and more importantly investment inflows, have mostly been with England and the Dollar economies. The Euro has fluctuated quite sharply, and in both directions, against the US dollar and the Pound. Indeed to get into the Euro in the first place, Scotland would have to show stability against the Euro for at least two years. Since the Pound fluctuates against the Euro, this would mean finding a way to peg against the Euro without damage from the beginning. This could prove to be a challenge. And to the extent the peg has to be enforced, it may imply somewhat larger fluctuations in income levels than we have been used to.

The final question is, how should the transition path to the Euro be managed? This must necessarily be speculative. First, the arbitrary nature of dividing up assets and liabilities will affect the starting position for the fiscal ratios and hence the ease of satisfying the fiscal criteria. Second, the transition path must resolve an obvious conflict within the exchange rate criterion: how to maintain a stable relationship with the Euro when you don't have your own currency and when the inherited currency does not have a stable relationship with the Euro. This would be messy.

The available options are:

i. permit the Euro to circulate right away;

ii. retain sterling for the probation period;

iii. create an independent currency pegged to the Euro using a currency board.

Each option has different implications for business confidence, inflation and competitiveness. Perhaps only a firm and credible currency peg will supply the necessary confidence in the markets. A third question is how to control the exchange rate so as to secure a favourable/competitive conversion rate into Euros for the moment when Scotland finally joins. Of the exchange rate options, only pegging your currency to the Euro in the probation period will allow for that. Similarly, the need to adopt new monetary institutions (a new central bank, a new monetary policy, interactions between monetary, fiscal and labour market practices) will affect credibility, confidence and inflation – and hence the ability to meet the inflation and interest rate criteria – as do measures to increase the depth and development of the Scottish financial markets. Again, it would pay to make an early start on those arrangements and a firm and credible currency peg to supply the necessary market confidence.

AN INDEPENDENT SCOTLAND OUTSIDE THE EUROZONE

This regime is the same as for Scotland in the Euro but with fewer restrictions. Fiscal policy would be set in the same way, but would not now be subject to the Stability Pact's deficit maximum of 3% of national income or debt limit of 60%. This would allow for greater fiscal activism, which many countries have found to be advantageous. But it may also open the doors to weaker fiscal discipline. And if the capital markets fear a build up of excessive debt, they will impose risk premia on Scottish interest rates. These risk premia can be substantial; an extra 2% to 3% on interest rates for Argentina in the best days of the hard dollar link and even 1% for the German states in the German Federation. And we have seen in the Eurozone, countries with poor fiscal or political discipline can often get significantly larger risk premia: from 5% to 7% for Ireland or Portugal, and 16% or more for Greece, above standard Eurozone financing rates of about 3% in the past two years.

On the other hand, these extra freedoms may not be very important in determining the level of public services we want to choose, since the restrictions are all on the *differences* between revenues and spending – not on the *size* of spending or public services. Scotland would be free to choose any level of public services as long as she can pay for it from revenues, as the Scandinavians do now. In the same way, fiscal policy would now be free of any formal or informal agreements to prevent tax competition - a strategy many countries have found to be very useful for boosting their long term development.

Lastly, Scotland would face some important decisions outside the fiscal area. Leading among these is again the choice of exchange rate regime: fixed, floating, currency board, or retain sterling? Then what kind of monetary policy: anti-inflationist, accommodating to growth and jobs, activist or not, coordinated with fiscal policy? What kind of central bank: independent; with an external or internal policy committee; accountable; a lender of last resort with responsibility for financial stability and oversight? Lastly, if outside the

EU, Scotland would have to develop her own trade policies – consistent with WTO rules – *and* her own prudential regulation of the financial markets.

ASSESSMENT: WHICH REGIME WOULD BE BEST FOR THE ECONOMY?

The traditional way to select which monetary arrangements (independence, or a currency union, or a currency peg to another country's monetary policies), would be most appropriate is to use the Optimal Currency Area analysis popularised by Mundell and MacKinnon. Optimal currency area theory sets out the conditions that need to be satisfied before it would be sensible, feasible or desirable to adopt the currency of another country, join a currency union with another group of countries, or adopt a currency peg to another economy. Any one of these choices necessarily implies accepting the monetary policies pursued in the partner country or group of countries. Otherwise monetary and fiscal policies will be set independently – but without support, constraint or risk sharing from outside parties.

At their simplest, the optimal currency area conditions are:

- The economy concerned must trade predominantly with, or be open to trade with the country/group of countries with which it proposes to share a currency;

- That economy must enjoy high capital mobility with the same partners;

- It must enjoy high labour mobility between itself and those partners (so that workers can move freely to jobs); or to have high wage flexibility so that it is easy to attract jobs to workers in bad times, and workers to jobs in good times. Evidently the former (labour mobility) is a solution to long term/structural unemployment or labour shortages, whereas wage flexibility would help deal with short term (cyclical) disequilibria. Note that wage flexibility can bring few advantages without capital mobility since jobs will not otherwise move.

- That economy must also enjoy a high degree of symmetry in shocks, and market or institutional structures, with its partners. If not, it will typically be out of phase or out of cycle with its partners; in which case the common monetary policies and spillovers from the fiscal policies pursued by the partner economies will typically be set wrong for, and have a counterproductive impact on, the home country. Differences in market and economic structures are important since, in such cases, even symmetric shocks will have asymmetric effects. To remove those effects would require changes in social and economic institutions, a freer use of market forces, or dismantling the specialisation in existing trade.

On the face of it, Scotland should satisfy the first three criteria pretty well in the context of the UK monetary union. The rest of the UK is Scotland's largest trading partner, followed by the dollar countries (including China for as long as the Reminbi-Dollar link may last). Capital and labour mobility with the rest of the UK are unrestricted, and sometimes all too evident in the outmigration direction. That may imply a structural problem in the Scottish economy. Wage flexibility is not so evident, at least not in the downward direction, as a result of UK-wide wage bargaining or wage arbitrage. Nevertheless, wages were 5% below the UK average in 2007, while productivity was only 3% lower. This implies that unit labour costs were 2% lower. Yet Scotland is not more competitive, with lower unit production costs, since otherwise her economy would have grown faster. Growth has in fact been between 0.5% and 1% slower on average over the past 35 years. That suggests that capital mobility has been less than needed; or equivalently that wage flexibility has been less than needed to sustain that currency union successfully.

Finally, the degree of shock or structural symmetry is usually measured by the correlations between business cycles as a measure of the extent to which the two economies are in phase; and hence of the probability that monetary (or fiscal) policy actions in one (the UK) will be suitable in the other (Scotland). This is a rather simplistic measure. But the correlation coefficient between the Scottish and UK cycles since 1975 has been only 0.65, although it has risen to 0.93 as recent developments and the financial crisis have eroded Scotland's commercial independence. This figure is broadly similar to the UK's correlation with the Euro-area (table 1). If a correlation coefficient of 0.59 is low enough to warrant the UK remaining out of the Euro, then the case for Scotland remaining in the UK monetary union is equally weak. Yet, Scotland's case for joining the Euro is no stronger. A more interesting figure in this context is the Scottish economy's high correlation with the G7, essentially the same as that with the UK, but with a lower income volatility (standard deviation of 1.59) than that of the UK (standard deviation 2.06). This suggests that a peg, or currency board link, to the G7 is a viable alternative to monetary union with the UK.

TABLE 9: CORRELATION COEFFICIENTS BETWEEN BUSINESS CYCLE GROWTH RATES IN SCOTLAND, UK, EUROZONE AND THE G7: 1990-2009.

	Scotland	UK	Eurozone	G7 countries
Scotland	1.0	0.93	0.64	0.93
UK		1.0	0.59	0.88

SOURCE
Authors calculations from UK Office for National Statistics data

That said, whether Scotland would actually fit the criteria better with respect to the Eurozone, or monetary independence linked to the G7 group of advanced economies[67], is doubtful. The Scottish economy is certainly open to trade with both groups. But they are not her main trading partners (although they could become so). Similarly, the Scottish economy is open to capital mobility to and from those groups. But they are not Scotland's principal source of investment or financing, even if the European and US investments have typically been more productive. Labour mobility with those two groups is definitely lower, wage flexibility is unlikely to be much affected and the business cycle correlations are lower in the European case (Table 9). Thus, on the face of it, Eurozone membership or full monetary independence are actually less likely to be advantageous for Scotland on purely economic grounds.

There is an additional argument here: adopting the currency and monetary policies of another country when the trade links are with a partner within the union, but capital and financing links are with a different partner outside the union, and the currencies of the two partners are likely to fluctuate or move apart (as the Euro and Pound have done), is a recipe for disaster. That was the proximate cause of the collapse in Argentina in 2001.[68] This speaks for staying with sterling on purely economic grounds, for as long as the UK remains Scotland's dominant trade and investment partner. However, the case for fiscal independence remains unchanged.

CONCLUSION

The failure to satisfy the optimal currency area criteria, and the last one in particular, is not sufficient reason to reject the associated monetary arrangements out of hand. In later writings, Mundell argued that a currency

67 Taking the G7 to represent Scotland's option of monetary independence is to recognize that, as a small open developed economy, Scotland would principally be subject to the performance of the G7 economies and the spillovers from the monetary and fiscal policies they undertake. Scotland's high correlation with the G7 suggests that a multilateral currency peg (or currency board) with the G7 is also a viable option.

68 Anthony and Hughes Hallett (2000)

union could still be appropriate if there were sufficient linkages between the capital and financial markets to compensate for a lack of correlation, the out of phase nature of the economic cycles. Risk sharing and stabilisation could still take place, even if the cycles are out of phase and the common monetary policies are to some extent inappropriate for one of the partners, if the linkage through the following channels is strong enough:

- Through the capital markets and cross-border ownership of shares and bonds (so that income levels in one economy in bad times is buoyed up by higher interest payments, capital gains and dividends from other economies in good times);

- Through the credit and loans channel, so that firms or consumers have easy access to finance (and hence smooth) their activities in bad times as well as good.

- Via fiscal transfers, automatic or discretionary, made between economies in the union, from the economy enjoying good times to the one suffering a downturn.

This view supports continuing the sterling link. Eurozone membership and monetary independence do not and are not likely to supply the same degree of capital market integration or fiscal transfers (although fiscal autonomy in either regime, or in the UK monetary union, can always do better than fiscal transfers since it can always be used to either reproduce those transfers or improve on them). But the real lesson from this extension of optimal currency area analysis is that a properly functioning banking system with reliable credit/lending channels is an essential component in any monetary regime. It is obvious that the transmission mechanism of monetary policy has broken down since the crisis in 2007 and needs to be restored as a necessary prerequisite for whatever regime is chosen. That implies a local banking system, and a hand in its regulation, will be needed to make monetary policy effective.

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CHAPTER 8
WHAT FUTURE FOR SCOTTISH BANKING?

BY PROFESSOR JOHN KAY

COULD SCOTLAND MANAGE ITS BANKS?

The collapse of Scotland's two major banks in October 2008 and their rescue by the UK government, was a setback for supporters of Scottish independence. The SNP First Minister, Alex Salmond, himself a former economist in the Royal Bank of Scotland, was wrong-footed by the crisis, which he had initially blamed on speculators. Opponents argued that an independent Scottish government could not have handled the crisis. The failure of Scotland's two largest companies seriously weakened the Scottish business sector and the reputation for prudence and competence of Scotland's financial services industry.

If Scotland had been independent in 2008 and events in the banking sector had evolved in a similar way, there would have been three broad categories of action available to the Scottish government:

- *the support option*: the Scottish government would guarantee most or all of the liabilities of Scottish banks
- *the internationalist option*: the Scottish central bank would take the lead in an international support operation for these banks
- *the resolution option*: the companies would go into some form of administration while the Scottish government took control of their retail and commercial activities within Scotland.

Although the head offices of both banks were in Edinburgh, both had substantial activities elsewhere. Only about one in six of the more than

200,000 employees of HBOS and RBS worked in Scotland and both employed more people in England than in Scotland. Any government faced with the collapse of banks whose head offices are located within its territory, but whose activities are mostly located outside it, faces similar issues. However, the size of the Scottish banks relative to the size of the Scottish economy poses the problem in particularly stark form. As in Iceland (and in contrast to Ireland) the activities which led to the collapse of the Scottish banks mostly took place outside the country.

Ireland adopted the first option – state guarantee of all liabilities - and it was a mistake. Certainly, it is not a decision which could responsibly have been made in Scotland. The liabilities of the two Scottish banks amounted to about 30 times Scottish GDP, or almost three-quarters of a million pounds per inhabitant of Scotland. Both these figures are substantially higher than the corresponding figure even for Iceland. Not only do most inhabitants of Scotland not have three quarters of a million pounds, but they do not expect to earn three-quarters of a million pounds in the course of their lifetime.

Once the scale of the problems faced by the Scottish banks become evident, the Scottish government's guarantee would simply not have been credible. Markets would have asked whether Scottish taxpayers would be willing or able to meet the potential liabilities. They would not have been readily convinced that political support for such action would continue even if Scotland had the capacity to meet these obligations. The government which had made such a commitment would have been turfed out, and deservedly so, as the Irish government was. Before that point the Scottish government, like the Irish one, would have had to seek international assistance, or abandon its pledges.

Of course, there are assets on the other side of the balance sheet and these are assets of better quality than those on the balance sheets of the Irish or Icelandic banks. But not only could the Scottish government not have known, even approximately, what their assets were worth, it is now evident the banks themselves did not know, even approximately, what these assets were worth. Senior executives of HBOS and RBS continued to give Panglossian accounts of their situation – evidently in good faith – until they were removed from office. The quality of Lloyds' due diligence on HBOS appears to have been execrable although Lloyds had greater capacity than any government to undertake such diligence, more time, and more incentive to do so.

But the central point is that a calculation that treats the liabilities of banks whose head offices are in Scotland as liabilities of the population of Scotland cannot be appropriate. There is no possible justification for the proposition that a Scottish taxpayer should pay off foreign institutions which made loans to ABN-Amro. The size of the liabilities of the Scottish banks makes the absurdity of such an assertion particularly clear. But it does not matter whether the denominator of the calculation is the population of Scotland, the population of the UK, or the population of Edinburgh. The liabilities of Scottish headquartered banks are not liabilities of the Scottish people, either morally or legally.

The support option would have been extremely risky, was almost certainly not sustainable, and could not in any event have been explained or defended to Scotland's taxpayers. The specific nature of the second option available to a Scottish government – the internationalist option – substantially depends on the currency arrangements which are in place. The paper in this volume by Andrew Hughes Hallett describes the three alternative monetary arrangements possible for an independent Scotland: a Scottish currency, membership of the euro, or a UK currency union. The logic of Scottish independence might be thought to point to an independent monetary system. Although the population of Iceland is only 300,000, that country had – and continues to have – its own currency.

The experience of Iceland illustrates the extent to which vulnerability is the corollary to freedom of action. The country considerably aggravated its difficulties by failing to accept advice or practical help from other Nordic countries until its crisis was unmanageable. There are serious limits to the reality of economic independence in a global world.

An independent Scotland might have broken the link to sterling and joined the eurozone. The Irish comparison offers a mixed verdict. Ireland's link to the euro and particularly to European interest rates contributed substantially to the inflationary boom in Ireland during the years up to 2007. After the virtual collapse of the Irish banking system in the autumn of 2008, the resources of the European Central bank, and the implied support of European institutions, put Ireland in a stronger position as a eurozone member than if the country had enjoyed monetary independence. And yet the cost of that European support was a serious loss of autonomy, as the new Irish government elected in 2011 quickly discovered.

Probably the best alternative, and probably also the likeliest, as Hughes Hallett suggests, is a continued monetary union with England. A Scottish peg to the pound sterling might be an informal arrangement. For many decades following Irish independence, that country linked its currency to the pound sterling in this way, effectively bound by UK monetary policy but playing no part in its formulation. An informal peg would have left Scotland almost as vulnerable in the event of a specifically Scottish crisis – such as the collapse of Scottish banks – as with a freely floating currency.

A formal monetary union with England is another possibility. The specific institutional arrangements for this would no doubt have been negotiated as part of the overall discussions surrounding any independence settlement. Such an agreement would, as the current Eurozone evolution illustrates, have necessitated considerable restriction on the fiscal policies of an independent Scotland.

But even if Scotland had been part of a monetary union with England, and had appropriately coordinated its fiscal policies, there could – and probably would - have been a distinct Scottish regulatory authority. The issues of monetary policy and financial regulation are substantially separable. In this scenario, although the Bank of England would have retained responsibility for the monetary policy of an independent Scotland, neither the Bank of England nor the English Financial Services Authority (FSA) would have exercised a regulatory role north of the border.

If Scotland pursued the internationalist option within a British monetary union it would have been to London and Washington, rather than Brussels and Frankfurt, that the first calls would have been made when the Scottish banks faced failure. RBS had large retail operations in England and the United States and London was the central location of its wholesale trading. The Scottish central bank governor might reasonably have been asked to explore a support operation in which the US and English governments took the principal role.

In the circumstances of October 2008, it is likely that willingness to provide such support would have been forthcoming. That is not, of course, the same as saying that it would have proved possible to reach an agreement. The conditions of the rescue would likely have been harsh – the English government would have expected to assume control of RBS and probably HBOS also, and substantial underwriting of liabilities by the Scottish government would have been required. It would have been critical to any satisfactory outcome from that negotiation that the Scottish government be willing to walk away – to contemplate the default option described below.

In the most closely analogous case – the collapse of Fortis, the equally unhappy partner of RBS in the ABN-Amro takeover – an agreement between the governments of Belgium, the Netherlands and Luxembourg to provide support fell apart when the scale of the losses became apparent. The Dutch and Belgians took unilateral action to assume control of operations in their own countries and the dispute was acrimonious. The failure of Fortis led to the fall of the Belgian government – not, it should be acknowledged, an infrequent occurrence.

The funds provided to Fortis by the national governments and the proceeds of sales of divested units were, however, sufficient to enable the holding company to remain solvent. The liabilities of the wholesale creditors of the bank were therefore discharged and insolvency of the parent avoided. But Fortis was predominantly a retail financial institution and its wholesale liabilities were not remotely on the scale of those of RBS.

The treatment of Fortis draws attention to the third option available. The resolution option is the default option – it is the one that will follow if there is no unilateral bailout (the support option) or agreement between central banks (the internationalist option). Understanding the consequences of the resolution option is therefore necessary to determine how much effort, if any, should be devoted to pursuing the alternatives.

In the case of RBS and HBOS, resolution implies that the Scottish Government would take control of the retail activities of the bank while the company as a whole went into administration. The presumption would be that the English and US governments would do the same in respect of commercial banking operations in their own countries.

The English government would have had the option of acquiring the investment banking and trading operations of the Scottish banks. Such an option might be exercised through emergency legislation in England, purchase from the administrators, or an immediate offer to the holding company. The Scottish government would have a similar option, though it would have been foolish to have exercised it. It would also have been extremely foolish for the English government to have exercised that option, but more likely that it would. There would have been strong pressure from the international financial community to follow that course.

The implications of the failure of RBS, in particular, for wholesale financial markets would have been severe. The deposits of retail customers would have been protected and everyday banking activities in all countries would have continued as a result of the nationalisation of these operations by respective governments. But the impact on global markets would have been greater than the consequences of the collapse of Lehman. The process of administration, and the litigation that would inevitably have surrounded it, would have provided lucrative employment for Edinburgh professionals for many years.

This resolution process would have been the least bad option for the Scottish government – and unless the Scottish government had been willing to contemplate it, no remotely acceptable terms could have been exacted in the fraught negotiations which might have led to an international support operation. The contrast between the current situation in Iceland – which is recovering rapidly from the effective winding up of its pre-2008 banking system – and Ireland - in which the burden of supporting its failed banks appears an ever more serious obstacle to economic development, emphasise the attractions of the default option.

But the problems posed in 2008 by a collapse of RBS would have been more serious than necessary. The mess would have been especially serious because the UK, US and most other countries had no effective mechanism for the resolution of large failed banks, especially those operating internationally.

The situation is now somewhat better, as a result of new legislation and institution of living wills – minor failures such as that of Northern Rock could today be managed much better than in 2007-8. But there is little advance, either domestically or internationally, in managing the issues posed by a major failure. There is effective resistance to the implementation of measures to facilitate resolution, partly because this would involve simplification of the corporate structure of banks – increasing their tax liabilities and inhibiting the cross subsidy of investment banking from retail deposits, and partly because the absence of such resolution procedures increases the pressure on governments to treat banks as 'too big to fail'.

Might regulation of RBS and HBOS have averted collapse? Regulation in Scotland would have to be undertaken in an international and European context. For the last two decades, international regulation of banks has been based on the Basel agreements. These rules are principally focussed on capital requirements, imposing a ratio of equity and near equity to risk weighted assets. Reserve requirements have been less demanding for banks whose internal risk management processes were considered appropriate. In practice, the assessment of risk management capabilities meant encouragement to use a variety of models based around the concept of value at risk.

Regulations of capital and of models proved worse than useless. Capital requirements were actively damaging through the stimulus given to regulatory arbitrage. The prescription of reserve ratios encouraged the creation of securities and off balance sheet vehicles whose effect – and in most cases primary purpose – was to reduce the need for regulatory capital. More broadly, the Basel regulations undermined management responsibility for risk management. It should hardly need saying that determining the capital requirements of a business is a management responsibility, not a regulatory obligation.

Would an independent Scotland regulatory authority have managed matters better than the United Kingdom's FSA? There are two conflicting considerations here. Small countries are more vulnerable to what is often called crony capitalism. The business and political elite consists of a limited number of people, who know each other well. There is a perception of common interest. In many respects this community of interest is valuable – homogeneity of outlook and informality of process can be a competitive advantage in business and small European states have derived economic benefit from it. But in both Iceland and Ireland the links between politics and finance were certainly inappropriate, if not actually corrupt. Crony capitalism contributed substantially to the financial crisis in both countries.

It is hard to believe that Scotland would have entirely avoided similar dangers. The palpable – and justified – pride which was taken in Scotland over the international expansion of the Royal Bank would almost inevitably have encouraged an identity of interest between the Scottish government and Scotland's largest business. Nor would such an identification have been wholly a bad thing. But it would almost certainly have been a bad thing when regulatory action to constrain excessive risk taking or to discourage unduly ambitious acquisitions was required. Excess of ambition and of willingness to accept risk was characteristic of both major Scottish banks in the years before 2007.

There is, however, an opposing consideration. Some countries were more effective than others in anticipating and restraining excess in their financial services industry. Many of the states which achieved this are small, and Australia and Canada are conspicuous among them. The more restrictive and conservative stance of financial services regulators in these countries was one differentiating factor. Scotland might plausibly have been more like Australia and Canada than England or the United States.

But the issue is complex. The regulatory stance is not exogenous. Regulatory capture – the tendency of regulator to see the industry through the eyes of the principal firms in the industry – is endemic in financial services. If Britain and the United States got the regulation the City and Wall Street wanted, Canada and Australia got the regulation Toronto and Melbourne wanted. Regulation in these latter countries bolstered what was already a more conservative banking environment. The influence of retail bankers on conglomerate banks in Canada and Australia was much greater than in the UK where American investment banks, and other banks which had adopted their culture, have been the dominant force.

It is certainly possible that Scotland might have been more like Canada and Australia and that a relationship between regulators and bankers might have sustained the traditionally more conservative Scottish financial services stance in the face of international and market pressures in the years up to the crisis. We do not know. We do know that distinguished boards of RBS and HBOS failed to restrain excessive ambitions and risk taking on the part of senior executives mostly drawn from that Scottish banking tradition. A Scottish regulatory authority might have done better than the FSA and the RBS board, but there is no compelling reason to think it would.

The cost, or strictly speaking the exposure, which the UK government incurred in bailing out the Scottish banks would have been beyond the resources of the Scottish government. Some have drawn from this the conclusion that Scottish independence, even if desirable, is an impracticable dream. The premise that Scotland could not have handled the bailouts as the UK government did is correct. But the conclusion that this demonstrates the impossibility of independence is wrong. The Scottish government probably would not, and certainly should not, have done what the UK government did. But although the UK government was able to do what it did, the UK government should not have done it and should certainly not do it again.

RBS and HBOS, like other financial institutions, received support from the UK government because these organisations were viewed as 'too big to fail'. But neither a democratic society nor a market economy can contemplate private sector organisations that are 'too big to fail'. Such a company represents a concentration of unaccountable private power, answerable neither to an electorate nor to a market place. And 'too big to fail' destroys the dynamism that is the central achievement of the market economy.

It is preposterous to suggest that since modern, diversified, conglomerate banks are too big to fail, it is necessary to create governments whose resources are many times larger than those of diversified, conglomerate banks. The 'too big to fail' problem must be tackled in other ways than adapting our political system to the aspirations and needs of megalomaniac financiers and it can be tackled in other ways.

Limits on the size of banks are urged by some, but it is more important to limit their scope than to limit their scale. Financial conglomerates are riven by clashes of culture and conflicts of interests: contagion within institutions has meant that failures in relatively small parts of their operations have jeopardised the survival of the entire company. The government guaranteed retail deposit base has been used as collateral for speculative trading in wholesale financial markets.

Far from making financial conglomerates necessary, financial innovation has reduced the necessary size and scope of banks by establishing active markets in risk and maturity transformation. These market developments mean that diversification need no longer be managed within a single institution. Financial innovations are capable of reducing substantially the risks associated with retail banking, but have been used inappropriately to bring about precisely the opposite result as the wholesale operations of banks have not only assumed but magnified the risks that their retail arms have discarded.

The best future model for Scottish financial institutions is one in which the utility of normal commercial banking is separate from the casino of investment banking – Vickers on steroids. Retail banking should return to a conservative model. Risk-taking activities should be undertaken only by people who not only have skin in the game – who share losses as well as profits – but who derive capital, both debt and equity, from external investors who have a direct commercial relationship with the risk takers.

The European single market allows banks to operate in other member states either through branches – in which case the home country remains responsible for regulation and deposit protection – or through subsidiaries – in which case the host country assumes these obligations. Scotland should insist that banks headquartered in Scotland should use a subsidiary structure for their activities outside Scotland to establish that the Scottish taxpayer is not expected to compensate depositors outside Scotland.

Insistence that action to change the structure of the financial services industry can be taken only if there is international agreement is, as those who present this argument know well, a recipe for no meaningful action at all. These issues can and, if necessary, should be addressed unilaterally by the Scottish, English or UK government as the case may be. It is, of course, necessary to consider the implications of any policy for the competitive position of Scottish financial institutions; although this issue should always be subordinate to the wider interests of the Scottish economy and should in no circumstances include implicit or explicit guarantee by the Scottish taxpayer of trading activities located in London or New York.

The history of financial services in Scotland since the eighteenth century has been one in which a reputation for prudence has been no obstacle to ambition. The events of recent years, in which ambition ran ahead of prudence, proved in the long run to damage rather than to enhance competitive advantage.

The banking crisis, and the 2007-8 crisis more generally, does illustrate the limits of the economic independence or autonomy which Scotland – or any small country – can enjoy while it participates in a global trading environment and capital market. Scotland will inevitably either be part of an explicit currency union, or at least have its currency formally or informally linked to the currency of larger states. Such linkage has implications not only for monetary policy, but also for policy towards the financial sector and the ability to impose regulation: linkage into the global financial system through monetary union inevitably involves restrictions on fiscal policy. But the banking crisis neither strengthens nor weakens the case for such greater economic autonomy or independence for Scotland as can be achieved.

CHAPTER 9

THE SCOTTISH FINANCIAL SERVICES SECTOR AFTER THE GLOBAL FINANCIAL CRISIS: CELTIC EAGLE, SPARROW, LION OR HARE?

BY KEITH SKEOCH

"As sparrows eagles, or the hare the lion, if I say sooth, I must report they were."
Macbeth Act 1, Scene 2

The financial services sector in Scotland has a long, proud and well-documented history. Its banking antecedents can be traced back to 1695, its Life Assurance roots back to 1743. The founding of the Scottish American Investment Trust in 1873 also played an important role in the creation of the UK's fund management industry. While the lineage of the Scottish Financial Sector is impeccable, its economic importance has waxed and waned. Much of the long-term story has been one of relative decline as it failed to press home its early mover advantage. The more recent past however, saw a period of robust revival, which saw the sector's weight increase in both the Scottish and UK economy. The increased confidence prompted Alex Salmond to suggest "We have everything it takes for a Celtic Lion economy to take off"[69] and described financial services, along with energy and biotechnology, as the "vibrant core" of the Scottish economy.

While the sentiment was laudable, the timing was unfortunate as the speech pretty much marked the peak in activity. The global financial crisis took hold and growth slammed into reverse. Provisional data for 2010 suggest that the financial services sector was 20% below its peak level of output in 2007. This is a much sharper decline than experienced by financial services in the

69 Alex Salmond, 2007

rest of the UK or indeed London. This raises two inevitable and interrelated questions. First, whether the vibrancy was just another illusion created by the credit fuelled boom in global banking and financial markets. Second, whether in the wake of the crisis the sector still represents part of the vibrant core of the Scottish economy? This paper not only looks to answer these questions but also looks at the policies required if financial services are to remain a core driver for Scottish economic success.

THE SECTOR SOARS 1998-2007

Before the global financial crash the sector made a significant and increasing contribution to growth in the Scottish economy. Larreina[70] provides a comprehensive analysis of the sector and its relationship with the local economy. He points out that the sector's weight in GDP rose from just over 4% of Scottish GDP in 1998 to 7.6% in 2006. This 84% increase in the importance of the sector in the five years to 2005 was much faster than the 57% increase in London and the 25% experienced in the rest of the UK. Over the same period, Scottish output increased by 15% and financial services accounted for 45% of the growth. The dependence of other sectors on financial services also increased considerably. Intermediate sales of other sectors to the financial services sector increased from 10% to 17% with, as Table 10 shows, high levels of dependency in what might be described as ancillary services, which accounted for over 11% of Scottish GDP.

TABLE 10: SCOTTISH INDUSTRIES HIGHLY DEPENDENT ON THE SCOTTISH FINANCIAL SERVICES INDUSTRY. AVERAGE 1998-2003

	Sales to the Scottish financial industry / Total sales of the sector	% of Scottish GDP
Postal Services	40.07%	0.6887
Accountancy Services	29.01%	0.6656
Other Business Services	19.37%	2.5669
Advertising	18.71%	0.1544
Computing Services	18.22%	1.4195
Owning and dealing in Real Estate	18.11%	0.9607
Printing and Publishing	17.60%	1.1372
Market Research	16.96%	0.5759
Legal Activities	16.27%	0.9044
Telecommunications	15.93%	1.7259
Air Transport	13.38%	0.4052

SOURCE:
Larreina

70 Larreina 2008

This significant increase in inter-dependency created some potentially very strong multiplier effects than run from the financial sector to the rest of the Scottish economy. Table 11 below suggests that the full effect of a £1m increase in demand from the financial services sector could result in a £1.7m increase in the output of the whole economy after a period of five years with 95% of the impact felt within two years.

TABLE 11: ANNUAL INCREASES OF OUTPUT AFTER A £1M. SHOCK IN THE FINANCIAL SERVICES INDUSTRY OCCURS. AVERAGE OF 1998–2003 PERIOD

£m.	Shock	1 year after	2 years after	3 years after	4 years after	5 years after	New equilibrium
Annual increase in output	1	0.443	0.149	0.051	0.018	0.007	0.006
Accumulated increase in output	1	1.443	1.592	1.643	1.661	1.668	1.674

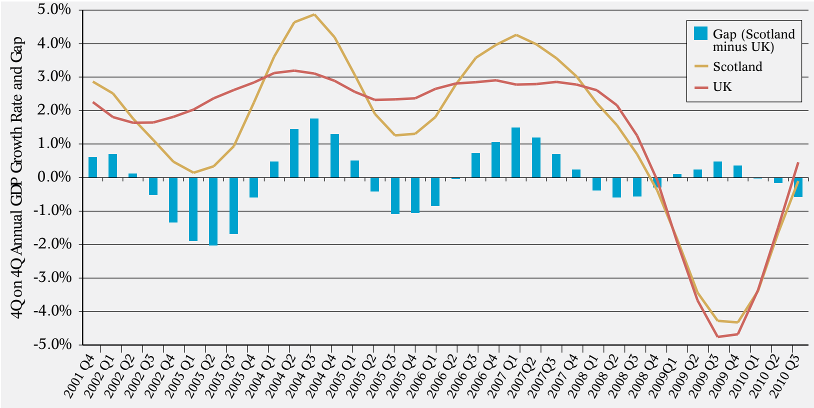
SOURCE
Larreina

These powerful effects serve to illustrate that during the financial boom the sector was not only growing strongly, but increasing its critical mass within the economy. They also give an initial sense of the potential downside from the financial crash. Theoretically, a 20% drop in the output of the sector could reduce output by 34% after five years assuming nothing else changes. This would strip up to 2.5% out of overall growth. This increased exposure and the more general effects of Bernanke's financial accelerator[71] created the conditions for some very severe headwinds that could have depressed economic activity for several years.

However, there is little evidence to suggest that Scotland's macro economy has suffered disproportionately. Figures 5 and 6 below show the performance of Scotland relative to the UK and the smaller European economies. If anything, the trough in the Scottish economy was shallower than its counterparts. The notable exception is Ireland, once lauded as the Celtic Tiger and the clear inspiration for the Celtic Lion, where the economy has imploded under the debt burden imposed by the rescue of its banks and collapse in its housing market.

71 Bernanke, Gertler & Gilchrist 1996

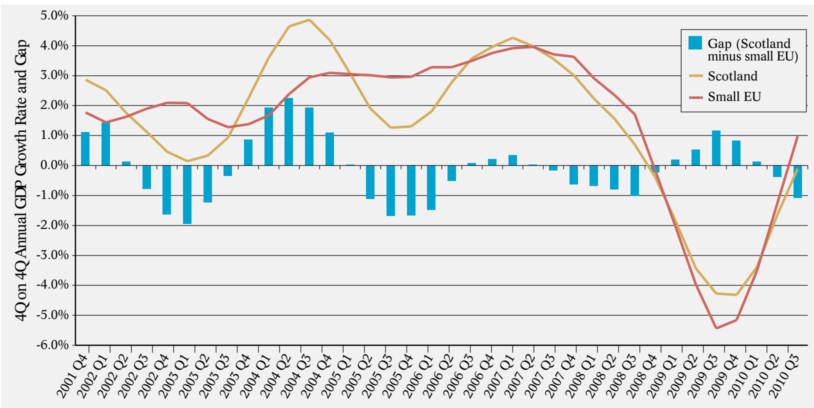
FIGURE 5: SCOTLAND AND UK ANNUAL GDP GROWTH RATES AND GAP, 2001 Q4 TO 2010 Q3



SOURCE

Scottish Government, ONS

FIGURE 6: SCOTLAND AND SMALL EU COUNTRIES ANNUAL GDP GROWTH RATES AND GAP, 2001 Q4 TO 2010 Q3



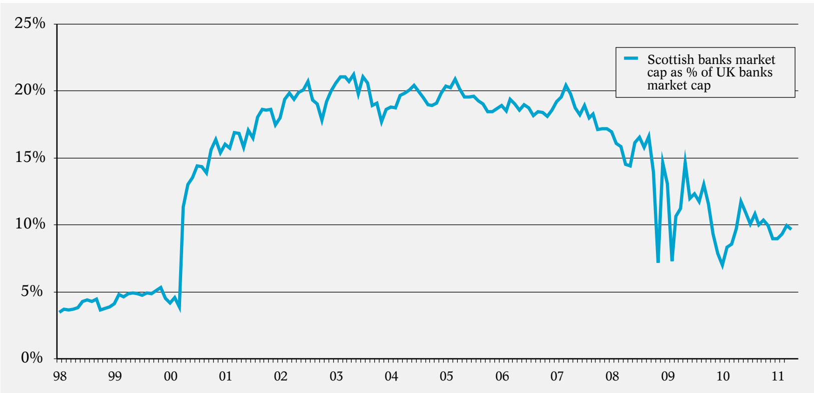
SOURCE

Scottish Government, OECD

CRITICAL MASS RETAINED DESPITE CRISIS

So why has Scotland not suffered disproportionately? One explanation is that the global financial crisis had very uneven effects across the financial services industry. The real implosion took place in the banking and housing sectors with the associated spill over effects into the rest of the financial and real economy. The banking sector in Scotland was hit very hard with RBS in effect taken into public ownership; a distressed HBOS was swallowed up by Lloyds, itself the subject of a public bailout and the customer base and branches of Dunfermline Building Society was acquired by the Nationwide after it became clear that it was no longer viable. Figure 7 below shows movements in the market capitalisation of Scottish headquartered banks vs. other UK banks listed on the London Stock exchange between 1998 and Q1 2011. It is remarkable given the impact on banking and associated 20% drop in financial services output that the Scottish economy has not suffered even more.

FIGURE 7: SCOTTISH BANKS AS % OF UK BANKS



SOURCE
Thomson Datastream

There are two strong candidates that might help explain why the effects of the banking bust and the financial accelerator may have been ameliorated. First, though both RBS and HBOS were headquartered in Scotland, the asset quality and liquidity problems that contributed to their collapse had very little to do with regional location of their headquarters. This also meant that in the case of RBS and HBOS the bulk of their labour force was located outside Scotland. The second factor relates to the difference between weight and critical mass within the Scottish financial services sector. While the banks undoubtedly played an important role in increasing the weight of financial services they were by no means the sole contributor to the increase in its critical mass. Insurance, Fund Management and Support Services are industries of national and international significance in their own right. They have made their own independent contributions to the critical mass of the Scottish financial services industry and have continued to thrive despite the crash.

Seven UK Insurance companies have their headquarters based in Scotland, they account for £41.4bn of life and pensions premium or around 24% of all long-term business written in the UK. They also account for around 12% of all of General Insurance premium written in the UK and £414.7bn or 26% of the total assets under management of UK insurance companies. [72] The assets managed for insurance companies have provided strong foundations for a thriving Scottish fund management industry. In 2010, the assets under management (including those managed for UK insurers) of Scottish headquartered fund managers was £537bn or 16% of total UK AUM[73]. Since 2003, the AUMs of Scottish headquartered firms have risen by 125% from £238bn or 12% of the UK market.

The extent of the critical mass outside banking can be seen by looking at the composition of employment within the sector. In 2009, banking accounted for 39% of employment in the financial services sector compared with 21% in insurance and 40% associated with fund management and support services[74]. The fact that 61% of employment in the sector is associated with activities outside banking was a clear source of resilience for both the financial services sector and the broader Scottish economy.

In their highly regarded and timely study, Reinhart and Rogoff[75] show throughout history financial crises are, on average, followed by drops in output from peak to trough of 9.3%, where the recession lasts for around two years, and peak to trough falls in house prices of 35.5% that last on average for six years. Using this as a benchmark, the Scottish economy has fared reasonably well and compares very favourably with Ireland, as shown in Table 12 below. House prices can be seen as a real time bellwether for the health of any financial centre and it is worth noting that Edinburgh (-11.2%) significantly outperformed Dublin (-44.9%) and London (-20%) during the crisis. While the sector may have lost some of the vibrancy it exhibited before the crash and its weight within the economy has inevitably reduced, its inherent critical mass provided by its diversification beyond banking has proved resilient, which

72 Source ABI

73 Source IMA

74 Financial Services Skills Council 2010

75 Reinhart & Rogoff 2009

suggests that financial services remain a core sector for the Scottish Economy.

TABLE 12: ECONOMIC PERFORMANCE DURING AND AFTER THE GLOBAL FINANCIAL CRISIS

% from Peak Region	Output	House Prices	Unemployment Rate
R&R Global	-9.3	-35.5	+7%
2007 to 2010			
Scotland	-5.4	-10.3	+5.0
UK	-6.4	-13,1	+2.8
EU 16	-5.4	-2.9	+3.0
Ireland	-15.1	-37.2	+10.2
Switzerland	-3.2	+14.7	+1.6

SOURCE
Scottish Office, ECB, Reinhart & Rogoff

FADING INTERNATIONAL IMPORTANCE

Financial centres are critical to economic development as they connect savings with the investment opportunities and innovation that drive growth. Of particular importance is the fact that the sector connects Scotland with the global financial community.

According to the Global Financial Centres Index in 2011, Edinburgh ranked 29th in the world with a score of 600 points and Glasgow 46th with 571. Mainielli suggests that there are five key areas that drive financial centre competitiveness:-

1.) *People* – the availability of good personnel and flexibility of labour markets
2.) *Business environment* – regulation, taxes and levels of corruption
3.) *Market Access* – levels of trading, clustering effects of many financial services firms in one centre
4.) *Infrastructure* – the cost and availability of property and transport links
5.) *General Competitiveness* – the concept that the whole is greater than the sum of the parts

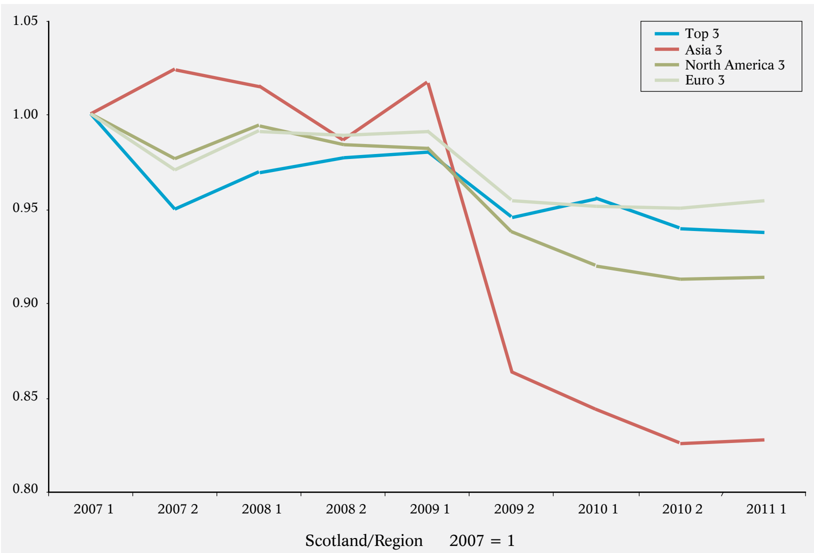
Edinburgh is seen as a deep and broad international centre with a strong showing in all categories. Glasgow fares less well in terms of market access and is seen as a strong local centre. While detailed economic data by sector is sparse, the GFCI produced its first ranking in early 2007 and so provides some insights into how the world's financial centres have performed in the aftermath of the financial crash. Edinburgh, Scotland's largest financial centre slipped from 15th place in 2007, when it ranked alongside Boston and

Toronto, to 29th where it is sandwiched between Dubai and Qatar. Glasgow ranks alongside Copenhagen and Rome at 46th having slipped from 22nd in 2008. The relative decline of Scotland as a global financial centre is shown in Figure 8 below. Its reputation as a global financial centre appears to be fading with only Dublin suffering a steeper decline from a peak of 10th place in 2009 to 33rd in early 2011, which must be concerning given the differing degrees of economic dislocation.

Edinburgh's absolute score has hardly changed from the 605 it registered in the first survey in 2007, its decline has been relative and others have simply become more competitive.

So where stands the financial services industry in Scotland post the global crisis? Although it's a long way from being the king of the financial jungle and it isn't soaring quite as high as it once did, the sector is no sparrow. Resilient and robust are terms that come to mind and the sector certainly is a core part of the Scottish economy and a vital component of its connection with the global economy. It has, however, lost some of the vibrancy and momentum that propelled it in the run up to the crash. The question facing policymakers is whether anything can be done to reinvigorate its flagging fortunes.

FIGURE 8 SCOTLAND RELATIVE TO TOP 3 AND REGIONAL TOP 3 FINANCIAL CENTRES



POLICY MATTERS – BRAND, PEOPLE & TAX

To be successful, policy needs to recognise that even if the sector fights as fiercely as Macbeth and Banquo, it will never be a big beast in the world of global financial services. Policy, like the hare that out manoeuvres the lion in Sanskrit literature, will need to be nimble and use its wits to win. In this context, Scotland's policy makers must first take heed of the fate suffered by both Ireland and Iceland, which as small economies were forced to bail out over leveraged and oversized banking sectors with disastrous consequences for both their national debt and future growth. As such, small, open economies should concentrate on developing the capital-light side of the financial services sector, i.e. the components that largely depend on some combination of human capital and technology to deliver products and services to clients for their success, rather than balance sheet expansion.

Policy for some time has recognised the importance of people, technology and infrastructure and the work of Scottish Financial Enterprise (SFE) and FISAB has helped to maintain the sector's critical mass by perpetuating a sound business environment with a strong and respected legal structure. Access to the world's capital markets is good, while Scotland may no longer have its own stock, money market or commodity exchange, in the digital world these are increasingly de-materialised and location of those who use (rather than run) the capital markets is becoming less of an issue. Infrastructure is clearly an area where upgrades are required, as the 2010 issues with the impact of the snow on air and road travel make all too clear. However, policy is not creating the additional impetus needed to compete with the other strongly rising financial centres in the world, especially in Asia where they also have the benefit of strong economic momentum. So what, if anything can be done? Three areas stand out people, tax and what might be loosely termed brand.

One of the consequences of the critical mass that has been built up is that there are no silver policy bullets that will significantly reinvigorate the fortunes of the sector.

Financial services increasingly operate in the weightless world where trust counts for a great deal and helps define reputation. The key to strengthening Scotland's financial service brand is re-defining what it wants to be known for – what is its specialism, why should it be seen as a centre of excellence serving the rest of the world? Hamilton in Bermuda is seen as a centre for reinsurance. Luxembourg is rapidly establishing itself as a centre of excellence for fund administration particularly for SICAVs, which are becoming the international mutual fund of choice. It is far from clear what Scotland's specialist offering is and why this should be a source of future competitive advantage. There are still significant opportunities and it still has huge strengths in fund management. In the pensions sector, the increasing use of defined contribution rather than defined benefit schemes around the world brings with it the chance for insurance companies to build on their natural strengths and heritage. Policy makers could build on both these strengths and opportunities and make it clear that as a long term aim they wish to see Scotland as a global centre of excellence for these areas and set about attracting high value added businesses and jobs. There is also little sense in Edinburgh and Glasgow being seen as separate financial centres when they are geographically so close and offer complementary services. A single Scottish financial centre should be marketed to the rest of the world.

A strong brand is required if Scotland is to attract the talent it needs to build a centre of financial excellence. Mainelli, [76] in his analysis of what makes a financial sector successful, suggests that for those with critical mass, people are the key area of competitiveness. *"…more and more advanced skills are required to win and transact more and more complex transactions – transactions of advanced financial, structural, and legal complexity in multiple languages"*. This suggests that Scotland should start to focus on what is required to attract talent to come and work in its financial services industry rather than mainly stressing the quality of its indigenous talent and strengths of its domestic education system. Centres of excellence create their own gravitational pull for talent and people networks are essential components of financial services. Neither New York nor London recruit solely from their indigenous population, but rely heavily on attracting talent from the rest of the world. Edinburgh, along with Zurich, offers an almost unique work/home environment and more should be made of this. Policy also needs to give thought to what else is needed to attract the talent, ensuring that some form of international schooling is available for an expatriate community's children for instance. Ensuring a welcoming international culture is in place and a stable political environment where diversity is respected and welcomed is crucial. Much of this may be in place, but one questions the extent to which this is understood by the world at large.

Scotland needs to signal that it is not only open for business, but is also business friendly if it is to attract the talent and companies needed to build on its strength and increase its competitiveness as a financial centre. The strongest signal it can give is through its tax regime. Mainelli[77] notes that although the GFCI groups tax in business environment "when you examine taxation on its own, it tracks business environment almost perfectly". Goldberg [78] notes that host countries with lower tax rates tend to attract more Foreign Direct Investment than those with higher rates. The evidence that a low tax rate makes a difference is overwhelming for both attracting

76 Mainelli 2009

77 Mainelli, 2009

78 Goldberg, 2007

high value added individuals and companies. One needs to look no further than the European attempts to force Ireland to raise its corporate tax rate and the Irish resistance to it. That said, a low tax rate by itself will never provide the spark to improve competitiveness and momentum. However, when the other building blocks are in place to create a critical mass, as they are with Scotland, it can make a massive difference for financial services centres. It is interesting to note that there are almost no poorly regulated tax havens [79]. Hong Kong and Luxembourg serve as very good examples of strong governance environments where the long-term commitment is also in place to a low tax regime. It is the long term commitment, which brings with it the macro need to maintain political stability around budgetary discipline, low national debt and a strong credit rating that makes the difference and provides the spur for improved competitiveness, innovation and growth as well as the gravitational pull for business and talent.

Scotland's financial services industry has weathered the global financial crisis well given the importance of its banks in driving growth during the boom. The robust and resilient critical mass revealed in recent years suggests that it is, and should remain, a core component of the Scottish economy not least because it provides a critical connection with the rest of the world. Also, financial services may be deeply out of fashion, but the needs of savers have never been greater and their demands will drive growth. Policy must move beyond a domestic agenda and operate in a global context. It needs to focus on attracting the talent and technology needed to build and grow capital light businesses to serve savers' long-term needs. Policymakers must accept that the evidence from the rest of the world suggests that a commitment to a stable, low tax environment is a key component if the decline in international importance is to be reversed and savers' needs met through domestically-based businesses.

79 Dhamarmapal & Hines 2006

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The views expressed in Keith Skeoch’s paper are the personal views of the author and should not be taken as representing those of Standard Life Plc.

CHAPTER 10
THE GREAT NORTH SEA OIL SAGA: ALL DONE OR STILL UNFINISHED?

BY PROFESSOR ALEX KEMP

IMPORTANCE OF OIL AND GAS DISCOVERIES

The discovery and exploitation of large volumes of oil and gas from the North Sea are among the most important events in the post-war economic history of the UK. Both the size and nature of the benefits have had major effects on the UK and Scottish economies. These effects were both direct and indirect and, given the large values involved, in each case their magnitude was substantial.

The direct effects of an activity are conventionally measured in terms of its contribution to gross domestic product (GDP). In turn, this depends on both the volumes and prices involved. The early discoveries in the Southern North Sea were of dry gas, and UK government policy at the time was to use the monopsony buying power of the Gas Council (later British Gas Corporation) to purchase the gas at cost-related prices rather than market values. The result over the years was that the very large volumes produced were not fully reflected in the conventionally measured contribution to national output. When large reserves of oil were discovered in the 1970s, their subsequent exploitation and pricing at full market values resulted in the combined contribution of oil and gas increasing rapidly to reach a peak of around 6.9% of UK gross value added (GVA) in 1984. The oil price collapse in the mid-1980s resulted in the share of oil and gas production to GVA falling rapidly to around 2%. In recent years, with the increase in oil prices the sector has still been contributing around 2% to total UK GVA.

ECONOMIC RENTS FROM PETROLEUM EXPLOITATION

But it is the composition of the value-added in the sector which makes its contribution to the national economy unique and adds an extra dimension to the policy issues. Over the years, large economic rents have been generated from North Sea oil and gas exploitation. These have contributed a major share of the total value-added. A substantial proportion of these economic rents have been collected to the state principally in the form of royalties and taxes. These grew very rapidly in the early 1980s to reach a peak in 1984/85 of over £12 billion in money-of-the-day (MOD) terms (£28.7 billion at 2009/10 prices). Subsequently, they fell at an equally dramatic rate to little over £1 billion in MOD terms in 1990-91 (£1.6 billion at 2009/10 prices). In recent years, following the increase in oil prices they have been nearly £13 billion in 2008/09, but fell to £6.5 billion the following year reflecting the major fall in oil prices in the second half of 2008. For 2010/11, the estimate is £8.8 billion. All these example figures are from UK government sources and thus reflect official accounting conventions. Thus, they exclude the Gas Levy which existed from 1981 to 1998. The revenues from it were quite substantial being over £500 million (MOD) annually for several years in the 1980s. Conceptually, they do represent tax revenues from North Sea exploitation, but the accounting convention employed by the Office for National Statistics is to classify the Gas Levy as an expenditure tax incurred (by BGC) in purchasing gas from a group of old gas fields in the UKCS. Over the period 1976-2011, the total royalty and tax revenues have amounted to over £285 billion (at 2009/10 prices).

LARGE INVESTMENT REQUIREMENTS OF SECTOR

While the size of government revenues and their volatility from oil and gas exploitation have attracted most public attention, other elements of the activity have also been remarkable. Thus, the investment required has been on a major scale. Field development expenditures have historically been the largest element. In 1975, when several major oil fields were being developed at the same time the expenditures reached an all-time peak of £11.5 billion (at 2010 prices). Since then, operating expenditures have gradually become relatively more important as the numbers of fields in production have grown. Thus in 2009 of a total industry expenditure of over £13 billion, field development expenditures accounted for just under £5 billion. There has been a substantial volatility in field investment activity. In 1984 it was just under £8 billion (at 2010 prices), but in 1986 and 1987 it had fallen to little more than £4 billion (at 2010 prices) as a consequence of the collapse in the oil price to $10 in 1986. This was followed by a major rebound and by 1990 field investment was over £8 billion (at 2010 prices). Following the price collapse in 1998, it fell to £3.6 billion (at 2010 prices) in 2000. It is well known that exploration is very sensitive to oil price movements as the financing of the activity is dependent on industry cash flows. But, because the expenditures in question are very much less than those on field developments, the direct effects on the economy are not so strong.

Investment activity in the North Sea has been important in relation to the whole economy. Thus in the mid-1970s it exceeded 30% of all manufacturing investment and in many other years exceeded 20%. The volatility has been pronounced reflecting the lumpiness of field developments which, in turn, was linked to exploration success rates and the levels of oil prices. There were serious repercussions for the oil-related construction industry in Scotland which has exhibited major fluctuations in orders and employment.

EFFECTS OF SECTOR ON BALANCE OF PAYMENTS

The exploitation of North Sea oil and gas played a significant role in the transformation of the UK balance of payments. Natural gas production from 1967 onwards reduced and then eliminated the need for naphtha as a feedstock, which the rapid growth of oil production from 1975 onwards led to a surplus of crude oil and product exports over imports from 1980 to 2004. In 1985 the trading surplus was a record £8 billion in MOD terms (£17.9 billion at 2009/10 prices) reflecting a combination of high production and prices. Crude oil production peaked in 1999 and has fallen substantially since then. The result has been a net deficit in trade in crude oil and petroleum products of £3.2 billion in 2009.

There are other noteworthy balance of payments effects. In the 1960s and 1970s large imports of capital equipment and other materials took place. The UK content in the early 1970s was only in the 30% - 40% range. The priority of the oil industry and the UK government was to obtain early production and, although British industry was certainly encouraged to bid for orders, expensive imports were required to ensure that early production was obtained. On the capital account there was a large inflow of funds to facilitate the financing of the huge capital investment. The requirements were beyond the normal capacity of UK banks which in any case lacked experience of the special conditions relating to oilfield finance. Much of the investment in the fields was undertaken by foreign oil companies. They brought both equity and debt finance from overseas. When the investment bore fruit, there were then corresponding outflows of loan interest and dividend payments which often reached very high levels.

By the early 1980s the UK balance of payments was transformed compared to the position for much of the 1960s and 1970s. The fast growing oil revenues certainly played a role in this and in the strength of sterling, though the extent of their influence was much debated. There certainly was a popular view that the influence was substantial and it encouraged Sir Michael Edwardes the chief executive of British Leyland to express the opinion in 1981 that it might be better "to leave the bloody stuff in the ground".

This view did not find favour with the UK government which had spent much time debating North Sea oil and gas policies since 1963. The key objective of licensing policy in the early years was to encourage exploration, development and production. Thus the original terms were relatively generous with respect to relinquishment and licence fees. Only conventional royalties and income tax/profits tax would apply to gas production. Gas would be rapidly utilised to displace imported naphtha in particular.

EARLY GAS PRICING POLICIES AND EFFECTS

But gas pricing was to be on a cost-related rather than market-value basis and the monopsony and monopoly powers of the Gas Council/BGC were employed to ensure that this policy was implemented. The result was a long period of negotiation over the long term gas contracts between the companies and the Gas Council with the government taking a particularly tough stance. The view within government was that gas prices should be kept relatively low to ensure that natural gas could outcompete naphtha and also permit the Gas Council to finance the huge expansion of the gas transmission system and convert all gas appliances from town gas to natural gas. Both of these activities involved large expenditures.

The consequence of this policy was that the economic rents from the exploration of North Sea gas in the 1960s and 1970s were effectively diverted to gas consumers and the Gas Council /BGC rather than to the state and thus taxpayers as a whole. The main early gas contracts signed in the 1960s involved very large volumes, with all the fields in question producing into the twenty-first century. While the initial base prices were not far from the fuel oil price, and thus arguably not far from a market price, the complex escalation clauses were very restrictive and over the years the gap between the contract prices and any realistic market value became very large. The general switch by households to gas central heating in the 1970s was accelerated by the pricing of oil at full market values, while that for gas remained on a cost-related basis. Eventually the difference became so pronounced that in 1980 the Government raised gas prices by 10% in real terms for three consecutive years and introduced the Gas Levy on BGC. It will be recalled that inflation was also at very high levels at this time.

SPECIAL TAXATION SINCE 1975 AND ITS EFFECTS

Oil policies were distinctly different. While only minor use was made of licence auctions, a special tax system was introduced in 1975 to ensure that the economic rents from oil exploitation were to a large extent collected by the government. Little thought was given to the idea of controlling oil prices. The main instrument was the new Petroleum Revenue Tax (PRT). It may be described as a form of resource rent tax though it does not conform to the tax by that name developed in the literature. The essential features of the resource rent tax are that it is based on the cash flows after a specified internal rate of return has been obtained on the investment. The PRT has unorthodox and complex features, but broadly it is a field-based profit-related tax which is progressive in relation to oil price and investment cost variations. Over the years it was changed many times, reflecting changing perceptions about the size of the economic rents.

Royalties and corporation tax were also applied to the North Sea. At the time of the introduction of the tax package in 1975, these were both conventional by international standards and did not cause much comment compared to PRT which was the main collector of the economic rents.

Over the years, many changes have been made to the tax system in response to changing perceptions of the profitability of the North Sea activities. Thus the PRT rate was increased from 45% to 60%, then 70% and then 75% with reductions in the special allowances (investment uplift, volume allowance, and safeguard). These changes increased the overall yield of the tax and accelerated its timing and involved considerable controversy with the industry. But this was little in comparison with the introduction of a fourth tier of tax (Supplementary Petroleum Duty (SPD)) in 1981. The high oil prices prevailing after the Iranian Revolution and the outbreak of the Iran-Iraq war were the ostensible reasons for this substantial new tax which was levied at 20% on gross revenues minus a volume allowance. But the need to reduce the escalating Public Sector Borrowing Requirement (PSBR) was clearly a main motive. The top marginal rate of tax now exceeded 90% and there is little doubt that investment suffered as a consequence. In 1981, a record year for oil prices, there were no new field development approvals by the Department of Energy.

The subsequent collapse in oil prices led to the abolition of SPD and royalties on new fields as well as the introduction of enhanced allowances for PRT. The overall government take fell substantially with oil prices, with production also falling as a consequence of declining output in the first generation of giant fields and the limited additions from the smaller newer fields. The Piper Alpha disaster in 1988 subsequently diverted priority investment into safety enhancement measures. Exploration was incentivised, however, with reliefs for the expenditure being available at over 83%, with much lower rates applicable to the income from modest-sized discoveries.

All the above, resulted in the government take from PRT falling to negligible levels. The examination by the UK government of these developments resulted in the decision to abolish PRT on new fields in 1993 and reduce the rate to 50% on established ones. This astonishing move did actually increase revenues in the short term through the abolition of the generous relief for exploration, but it also meant that only corporation tax was levied on the profits of new fields. At the time, the government argued that there were no foreseeable circumstances in which tax increases on new fields would be justified. In other words, further substantial economic rents were not anticipated.

Subsequently, exploration activity suffered a decline as a consequence of the rate of relief being dramatically reduced. But new field development activity and thus production increased substantially. Both oil and gas output grew strongly in the 1990s to reach peaks in 1999 and 2000 respectively. The tax yield remained at moderate levels due to the relatively low prices for both oil and gas as well as the relatively low tax rate.

RECENT TAX INCREASES

The major increase in world oil prices this century rekindled government interest in the tax yield. The result was the introduction of the Supplementary Charge (SC) in 2002 at 10% with increases to 20% from January 2006 and then to 32% in 2011. The combination of price increases and tax hikes have greatly increased the yield. It is noteworthy, however, that taxable capacity has not increased in line with the oil price increase. Thus, between 2003 and 2008 development and operating costs have broadly doubled. Currently, for new fields under examination for development in the UK Continental Shelf the average field development costs is around $18 per barrel of oil equivalent (boe), with some being very much higher. When lifetime operating and decommissioning costs are added, the average total (undiscounted) cost is $33 per boe with some being in excess of $100 per boe.

As noted above, the UK government via the royalty and tax system has collected very large sums from the UKCS. There is ample room for debate on how efficiently the economic rents have been collected. The many discretionary changes reflect both design faults and the perceived need either to obtain short term revenues or to give incentives. By international standards the level of take was moderate in the early years, relatively high in the late 1970s and early 1980s, moderate from 1983 for a ten-year period, low from 1993 to 2002, and moderate but increasing from then onwards. But this does not indicate very much about its effects on the industry. The growing maturity of the industry with smaller field sizes and relatively high investment and operating costs per boe have a major influence on the profitability of operations, especially when the materiality of returns (as measured by the size of expected net present value) is a main determinant of investment decisions.

UTILISATION OF ECONOMIC RENTS FROM PETROLEUM PRODUCTION

Given their importance in absolute terms and as a share of the value-added in the oil and gas sector, the use of the tax revenues has been a subject of much interest since the 1970s. There was a lively debate in 1977, both publicly and within the UK government, on the subject. Unfortunately, the level of debate was not very sophisticated and some of the options were not given adequate consideration. While it was recognised that oil revenues constituted a windfall there was no emphasis given to the view that these revenues were conceptually different from, say, income tax or VAT. The case for an Oil Fund which, if properly managed, could ensure that the income from a non-renewable resource was invested rather than consumed to procure inter-generational equity, was inadequately discussed. There was some recognition that oil and gas reserves were part of the nation's capital stock and their depletion was akin to depreciation of that stock, but the debate did not emphasise the need for policies and mechanisms which ensured that the stock was maintained or enhanced.

The view which prevailed was that promoted by the Treasury by which the oil revenues should simply be considered as part of the general budget and used to bolster macroeconomic policies. Thus they would enable other taxes to be cut and/or the PSBR to be reduced. Interest rates would be lower than they otherwise would have been, and, as a consequence, investment would be higher than in the absence of the oil revenues. In practice the revenues were certainly treated as any other tax, but it is doubtful whether, when they were at their peak in the first half of the 1980s, they significantly enhanced investment. The investment to GDP ratio remained stubbornly low until the later 1980s. The conventional view is that the oil revenues were used for normal budget purposes and, as this was at a time of high unemployment, they helped to finance public consumption rather than investment.

DEBATE ON DEPLETION POLICY

In the 1970s and 1980s a major debate also took place on depletion policy, particularly with respect to oil but also to a lesser extent with respect to gas. As early as 1974, before the first barrel from the North Sea was produced, it became clear that potential oil production would grow very rapidly from 1975 to the early 1980s and the UK could become not only self-sufficient in oil but be a substantial net exporter for a number of years, then become a net importer again in the 1990s. The policy issue was whether to intervene and reduce the depletion rate in order to enhance security of supply in later years and possibly profit from increasing oil prices. In the 1970s and early 1980s when the debate on depletion policy was at its height there was a view that oil prices would continue to rise in real terms.

There was sympathy for an interventionist policy within the UK government in the second half of the 1970s and elaborate measures were put in place which enabled the government to delay the development of new fields and to order production cuts within limits and guidelines. The main perceived benefits were to enhance security of supply in the longer term and benefit from the expected higher oil prices. At the macroeconomic level there was limited support for the view that a reduction in oil production in the early 1980s would reduce the rate of appreciation of sterling which was perceived to be a problem for exporters.

In the event little active intervention on depletion policy took place. The only stated case was a two-year delay to the development of the Clyde field, but this was more a device to provide short-term alleviation to the PSBR because the British National Oil Corporation (BNOC) was the operator and major shareholder in the field, and delays to its development meant that public expenditure as defined for PSBR purposes was reduced in the two-year period. The deciding factor in the decision not to curtail the growth of production was the short-term loss of tax revenues associated with any cuts. In the early 1980s it would have been possible to have disallowed the so-called "upward profile variation" from field development plans requested by operators, as well as to impose cuts to agreed profiles, but the resulting losses in short term tax revenues were felt to be more important than any longer term benefits of enhanced security of supply or from higher oil prices.

In general, the non-interventionist policy has been correct. Cuts in production increase unit cuts above what they would otherwise have been. Delays in the receipt of revenues whether from production cuts or development delays are non-optimal if these receipts are wisely employed. If depletion rates had been curtailed in the early 1980s there would have been lower revenues at a time when oil prices were higher in real terms than at any subsequent date until 2007. Extremely low discount rates would have been required to justify slower depletion as an investment.

With respect to gas the early gas contracts were on a long-term life of field depletion basis. The details including the annual contract quantities were essentially determined by BGC's perception of its long term market plans. The Corporation was very concerned about security of supply in the UK market and to enhance this was keen to purchase imported gas. The Frigg contracts (UK 40% and Norway 60%) made a major contribution to supplies for the UK market. BGC in effect used its monopsony powers to pay relatively low prices to producers for the Southern North Sea and other British sources while paying higher prices for Norwegian gas where its monopsony powers did not apply. Arguably, given the scale of the volumes from Frigg, this retarded the further development of fields in the UK sector. This issue reappeared when BGC attempted to purchase very large volumes from the Sleipner field in the 1980s. This precipitated a major debate, with UK licensees arguing that this would greatly retard the further development of the UKCS. Eventually, the UK government refused to ratify the Sleipner agreement which then had to be cancelled. This was perhaps a risky policy at the time, but the result was a dramatic increase in gas production from the British sector and justified the decision.

CURRENT MATURITY OF SECTOR AND IMPLICATIONS

The current position is personified by an underlying situation where oil and gas production are declining steadily, with net gas imports being required on a substantial and growing scale. Net oil imports are small but expected to increase. Licensing policies are geared to fostering exploration and development. There has been a plethora of new initiatives over the past decade including Promote Licences to encourage very small companies with new ideas at the early exploration stage, the fallow block and field initiative to encourage licensees to work their acreage or trade it on, tougher relinquishment obligations, and the stewardship initiative, designed to ensure that licensees in mature fields are investing adequately to maximise economic recovery from their fields.

Third party tariffing for transportation and processing is now very common in the UKCS and the negotiation of tariffs between asset owners and potential users has often been very prolonged. A revised Infrastructure Code of Practice introduced in 2004 has been only partially successful in speeding up the negotiation process. Currently DECC can only intervene to made a determination when one of the parties makes a request for this. A new Energy Bill currently in Parliament will give DECC the power to intervene on its own initiative including the right to determine terms. But this will only be on an individual case by case basis. The government has shown little interest in full scale regulation of tariffs as applies to gas (but not oil) transportation in the Norwegian sector of the North Sea.

CURRENT EMPLOYMENT GENERATED

The current onshore impact of activity in the UKCS remains very substantial. For the UK as a whole direct employment (by oil companies) has been estimated at 32,000 and indirect employment (by the supply chain) at 207,000. Induced employment via the spending by employees directly and indirectly employed in the sector is estimated at 100,000. Over the years the supply chain has become increasingly competitive in international markets and total UK export-related employment is estimated at 100,000.

For Scotland direct and indirect employment relating to the UKCS have been estimated at 110,000. Induced employment is estimated at 41,000. Total export-related employment is estimated at 45,000.[80] Within Scotland the oil-related activity is heavily concentrated in the North East or Grampian Region. For many years the GVA per employee in this region has been very high in relation to the Scottish average, and the unemployment rate has been very low by national standards. An important contributory factor in the continuing high levels of employment in the oil and gas cluster in Scotland has been its sustained success in penetrating export markets. Thus over the period 1997 to 2009 exports from a consistent and fairly comprehensive sample of Scottish companies in the sector (though not 100% coverage) have increased from around £1 billion to £7.2 billion (in MOD terms). Export markets (including sales by foreign-owned subsidiaries) now account for over 42% of total sales of the Scottish oil and gas cluster compared to around 25% in 1997 and 31% in 2002.[81]

IMPLICATIONS OF ALTERNATIVE CONSTITUTIONAL ARRANGEMENTS FOR TAX REVENUES

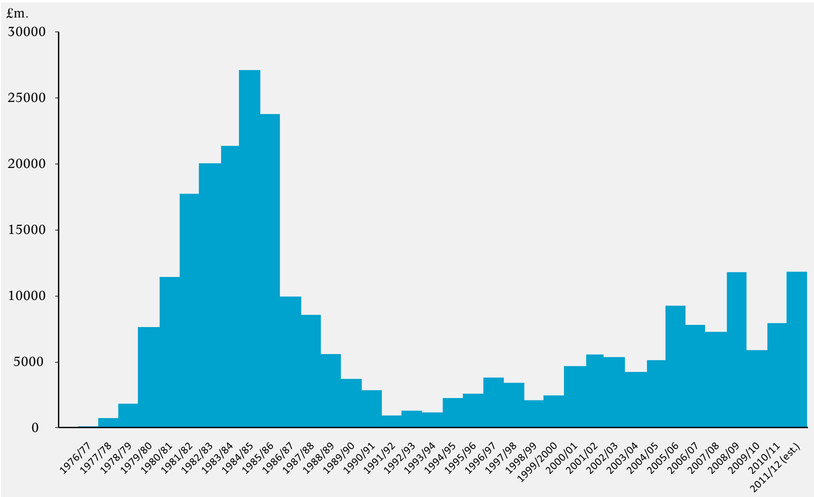
The above discussion has highlighted key features of the development of the UKCS under the current constitutional arrangements and policies pursued by the UK government. In this section the situation under alternative constitutional arrangements whereby major powers are devolved to a Scottish government are discussed. Currently rights over the exploitation of oil and gas in the UKCS rest with the UK government. If the rights had been given to a devolved Scottish government the question arises over which areas of the UKCS such devolution would apply. In practice with neighbouring independent countries the boundaries would be settled by negotiation. There is a presumption that the median line would be employed, but divergences from this have often occurred. An example in the North Sea relates to the boundaries between Germany, Denmark and the Netherlands. In the case of Scotland and the UK the median line has been employed to determine the line of demarcation for fisheries management purposes. This has been followed by Kemp and Stephen in two studies which have quantified the hypothetical

80 For all of the above estimates see Oil and Gas UK (2010), Oil and Gas UK 2010 Economic Report

81 For details see SCDI/Scottish Enterprise (2011), Survey of International Activity in the Oil and Gas Sector, 2009-2010

Scottish shares of expenditures and revenues from the UKCS.[82] These studies separate the activities of exploration, development and production according to the respective geographic areas of the UKCS attributable to Scotland and the rest of the UK. The studies also calculate the tax allowances and revenues attributable to these activities in the Scottish sector. This involved much detailed modelling and the validation of the results with the published data on tax revenues for the whole of the UKCS. The results for the revenues attributable to the Scottish sector are shown in Figure 9.

FIGURE 9 HYPOTHETICAL SCOTTISH ROYALTY AND TAX REVENUES FROM THE UKCS (£M. AT 2009/10 PRICES)



For the period from 1976/77 to 2010/11 inclusive the total tax and royalty revenues amount to £257 billion (at 2009/10 prices). Apart from their absolute size a key feature of the results is their volatility over the years. This is a function of several factors, particularly the behaviour of oil and gas prices, production, and the investment and operating costs, as well as the elements of the tax system itself. For many years the tax system has been predominantly profit-related and so the price sensitivity of the revenues is particularly marked.

82 See A.G. Kemp and L. Stephen (1999), "Expenditures in and Revenues from the UKCS: Estimating the Hypothetical Scottish Shares 1970-2003", North Sea Study Occasional Paper No. 70, University of Aberdeen, and A.G. Kemp and L. Stephen (2008), "The Hypothetical Scottish Share of Revenues and Expenditures from the UK Continental Shelf 2000-2013", http://www.scotland.gov.uk/Publications/2008/06/UKContinentalShelfRevenue.

It is clear that, if a Scottish government had control over these revenues, other things being equal, there would be a transformation in the public finances of Scotland. (It is, of course, by no means obvious that other things would remain unchanged if the oil tax revenues were devolved). The volatility may be expected to continue and there will be an inevitable long term downward trend despite the remaining substantial potential. Volatility of a substantial revenue source causes problems as the experience of Norway highlighted when the oil price collapsed in 1986. To deal with this problem two measures are desirable. The first is to have borrowing powers to deal with the problem when the revenues are low. The second is to have an Oil Fund into which oil monies are fed. The rules of the Oil Fund can be designed to put limits on the extent to which the monies can be used for normal budgetary purposes. At least some would be invested separately and the capital would not be available to the government for normal budget purposes. Only the income from the capital invested would be available for use. This procedure could procure inter-generational equity and help to maintain the nation's total capital stock as the oil and gas reserves were depleted.[83]

CASE FOR DEVOLVING OIL AND GAS REVENUES

There are several arguments in favour of devolving revenues from oil and gas exploitation in the case of Scotland. The industry is now an important one for the Scottish economy. But it is a non-renewable one and eventually the economic activities associated with its exploitation will run down as well. Measures then have to be taken to deal with this situation. The experience of the Scottish Highlands is illuminating in this respect. The employment in the oil construction yards exhibited enormous volatility in the period from 1970 to 2000 with disruptive booms and busts being experienced in local economies. These yards are now mostly closed and little or no permanent benefits have been received by some of the local economies. The availability of monies from an Oil Fund could play a useful role in preparing local economies for the post-oil era. The disruption payments negotiated by the Shetlands Council and the fund which has been established from these monies is a live example of the concept.

Sharing of oil revenues among different tiers of government is quite common around the world. In countries with federal governments the state or provincial government often has the mineral rights and royalties or taxes are justified on that account. There are also examples where a government which does not have the mineral rights either has taxing powers or obtains a share of oil revenues levied by another tier of government, to reflect the

83 For a detailed discussion of this see R. Hannesson (2001), Investing for Sustainability: the Management of Mineral Wealth, Kluwer Academic Publishers

importance of the industry to a particular region. This happens in Nigeria, for example. The concept of sharing of oil revenues is known in the UK. In 1968 under the Miscellaneous Financial Provisions Act it was established that the royalties and licence fees from the UKCS were to be shared with the governments of the Isle of Man and Northern Ireland on a per capita basis. Part of the thinking at the time was that the UKCS was enlarged by the existence of Northern Ireland and the Isle of Man. Provided that the Isle of Man government did not claim a continental shelf of its own it was felt that some sharing of the revenues in question was reasonable.

APPLICATION OF DERIVATION PRINCIPLE COMMON

Around the world with respect to the petroleum sector there are many examples of either royalty/taxation rights being devolved or revenue sharing arrangements between different tiers of government.[84] In the literature the derivation principle has been used to justify such arrangements. In the case of Scotland this principle can be employed to support the case for sharing or devolving revenues from the UKCS between the UK and Scottish governments. Thus when Scotland joined the Union in 1707 it brought with it what subsequently became a large and productive part of the UKCS. In essence the concept was recognised by the UK Government to a limited extent in the 1960s as noted above.

PRACTICAL TAX ISSUES

There is a clear difference between sharing of revenues with the powers over the tax system being retained by the UK government and devolving tax powers over the Scottish part of the UKCS to a Scottish government. Sharing the revenues in practice would be quite complex but not impossible. While PRT is levied on a field basis corporation tax and Supplementary Charge are levied on a UK ring-fence basis. Thus tax allowances generated by a field development can be utilised against the income of other fields anywhere in the UKCS. Procedures would have to be put in place to deal with this issue in order to find the appropriate division of the tax revenues between the two jurisdictions.

Devolution of taxation powers over the oil and gas sector would raise other issues, particularly if the Scottish government wanted to introduce

84 For details of several examples including Nigeria, USA, Brazil, Australia and India see Evidence from the Independent Expert Group to the Commission on Scottish Devolution (2009), Natural Resource Taxation and Scottish Devolution, http://www.commissiononscottishdevolution.org.uk/uploads/2009-06-06-ieg-natural-resource-taxation-1.pdf

tax terms different from those of the UK government. Some tax competition is in general desirable. A Scottish government might be more development oriented in its thinking as the onshore importance of the oil and gas cluster is very much greater to Scotland than it is to the UK as a whole.

While taxation policy is clearly of major importance to the industry the licensing arrangements are also important, particularly when the encouragement of activity in the sector is involved. It would be rather odd, though workable, if licensing policies were in the hands of one tier of government while taxation powers were held by another tier. A Scottish government, mindful of the importance of oil activities to the Scottish economy might be more reactive to changing conditions.

What a Scottish government would have achieved had it been in charge of the oil revenues from the Scottish sector can only be a matter of speculation. Clearly the opportunity for the transformation of the public finances of Scotland was there in the first half of the 1980s. Today the revenues remain very substantial though volatile. Much skill would have been required to utilise the revenues to good long term effect historically. The same can be said for the remaining possibilities if the opportunity were available.

SUBSTANTIAL FUTURE POTENTIAL FROM UKCS

The remaining potential from the UKCS is still very substantial. The most recent estimates of reserves and the ultimate potential published by DECC[85] have a central estimate of over 21 billion barrels of oil equivalent (bn boe) and an upper estimate of over 35 billion. These figures can be compared with 40 billion bn boe produced to date. The present author has recently undertaken independent detailed economic modelling of the long term prospects[86]. The resulting production under two plausible scenarios is shown in Figures 10 and 11 for the period to 2042.

85 See DECC (2011) UK Oil and Gas Reserves and Resources, https://www.og.decc.gov.uk/information/bb_updates/chapters/reserves_index.htm

86 See A.G. Kemp and L. Stephen (2011), The Short and Long Term Prospects for Activity in the UK Continental Shelf: the 2011 Perspective, North Sea Study Occasional Paper No. 121, University of Aberdeen, pp.61. http://www.abdn.ac.uk/~pec144/acreef/

FIGURE 10 POTENTIAL HYDROCARBON PRODUCTION $70/BBL AND 40P/THERM
HURDLE : REAL NPV @ 10% / DEVEX @ 10% > 0.3

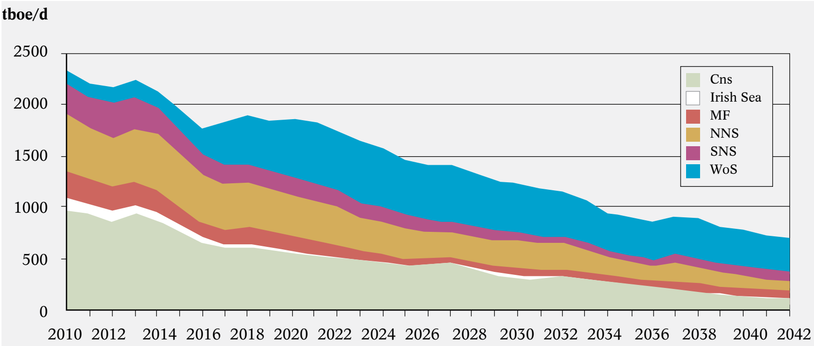
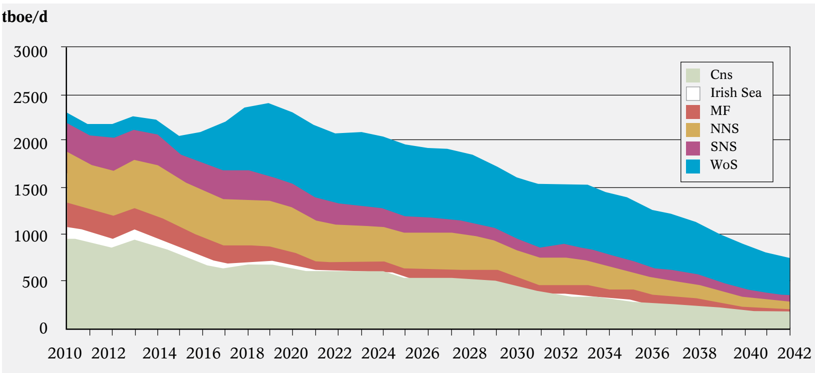


FIGURE 11 POTENTIAL HYDROCARBON PRODUCTION $90/BBL AND 60P/THERM
HURDLE : REAL NPV @ 10% / DEVEX @ 10% > 0.5



The results are shown by geographic areas of the UKCS, namely Southern North Sea (SNS), Central North Sea (CNS), Moray Firth (MF), Northern North Sea (NNS), West of Shetlands (W of S), and Irish Sea (IS). The fields in the NNS, MF, and W of S are all in the Scottish sector as defined above as are the great majority of the fields in the CNS. All the fields in the SNS and IS are in the non-Scottish sector.

In the $70 per barrel and 40 pence per therm (real) price case, while production continues to fall, over the period to 2042, 15.2 bn boe are produced. In the $90, 60 pence case 20.6 bn boe are produced over the period.

These figures are well within DECC's estimates of the future potential. Their realisation does require sustained substantial investment over a long period, but is consistent with that achieved in the 1990's.

The tax revenues which would be produced under these scenarios will clearly be very substantial. There will undoubtedly be some volatility. From Figures 10 and 11 it is clear that the great majority of the tax revenues will be attributed to the Scottish sector as defined by the median line. Over the next decade the annual values could be in the £5 - £10 billion range in real terms.

CHAPTER 11
IS THERE A NEED FOR A SCOTTISH EXCHEQUER?

BY BEN THOMSON

INTRODUCTION

This chapter explores the need for a Scottish Exchequer. It looks at how a Scottish Exchequer might be structured to run all of the treasury, financial policy, tax administration and collection, revenue and expenditure functions that might be transferred to the Scottish government.

The Scottish government does not currently have a treasury. This is not surprising as with no significant powers either to set and collect taxes or to raise borrowing, the Scottish Parliament simply has had no need for one under its existing devolved powers. The remit of the current Scottish government finance department is to set the allocation of budget received through the block grant from Westminster and to collect and analyse financial data.

Under the limited transfer of powers proposed in the new Scotland Bill, there will be a need for some treasury functions, particularly with regard to the new borrowing powers. However the level of fiscal powers transferred is less than 10% of current public sector expenditure and the main tax power to be devolved is setting up to 10p of income tax with no responsibility for tax collection or setting thresholds. Therefore, it is not really viable to do anything more than expand the current Finance Department of Scottish Government to handle the additional powers.

However, the Scottish government has announced its intension to hold a referendum within the term of this parliament and indicated that there are likely to be three options put to the electorate; Independence, some form of Home Rule, or the Status Quo. If either of the former two options are supported by the electorate and the UK government implements the chosen option, then significant fiscal powers will be transferred to Scotland.

This would present Scotland with an opportunity to create its own treasury, which I have called The Scottish Exchequer to avoid confusion with HM Treasury (Treasury). This chapter first looks at what role the Scottish Exchequer might take under Home Rule and how this might affect financial management and policy formulation in the Scottish government. It then goes on to extend the role the Scottish Exchequer might take should Independence be the preferred option.

In creating a new Scottish Exchequer, Scotland has a number of advantages. First, it starts with a blank sheet, so it is not locked into the history of development that leads to idiosyncratic practices. Second, there are plenty of examples to copy from around the world of where treasury functions have been made to work efficiently, as well as learn from the mistakes of those that have not worked. The creators of a new system should be shrewd enough to borrow the best of other systems and learn from the mistakes of others. Third, the Scots have a tradition for being bold and innovative thinkers: it comes as no surprise that President Obama quoted Adam Smith in his speech to the Westminster Parliament in 2011 or that Adam Smith is a favourite author of Deng Xiaoping, demonstrating Scots' influence on economic thinking in the world. Lastly Scotland's size with 5 million people should make it much more manageable to implement new systems.

In the debate over the referendum and the options put to the electorate, there needs to be clarity about how each option would work including how to manage borrowing powers and responsibility for revenues. If a Scottish Exchequer is formed it should be flexible enough to change as the relationship with the rest of the UK changes and should set the principles that will drive it. Part of the future debate should be about what those principles should be. It is my belief that an effective Scottish Exchequer should be driven by the following four principles:

1. **Integration**
   Many of the functions of Treasury have been divided in the past into different non-ministerial government departments or quangos. The Treasury has already started the process of integrating these into bigger quangos such as HM Revenue and Customs (HMRC) but still struggles with the legacy problems of the separate entities that were merged into it. It would be easier to consolidate the full responsibility for these functions into one central entity from the start so that the system of tax collection and benefits is better integrated. In addition given Scotland's population it does not need a separate Companies House, Stamp Office, Registers of Scotland and Inheritance Tax office.

2. **Simplicity**
   Tolles guide of tax legislation has doubled in length since 1997 to 11,520 pages, making it one of the longest tax guides in the world. It therefore comes as no surprise that 74% of MPs require accountants to help with their self-assessment tax returns. One does not need to be an expert to understand this is a system that is struggling under its own complexity. A key principle of a new Scottish Exchequer should be to simplify many of the financial structures. There is also an advantage to the rest of the UK, as UK tax guidance would no longer need to explain various Scots law differences in its forms and guidance.

3. **Transparency**
   There should be clear and honest reporting that allows ministers and their civil servants to take decisions and incentivises them to be efficient. It should also allow the public to analyse clearly and judge the performance of Scottish government. Adopting, for example, a corporate accounting approach to government with a proper profit and loss account and balance sheet would focus the administration on the difference between long-term capital expenditure and balancing current expenditure.

4. **Efficiency**
   There is far too much inefficiency, both between different layers of Government and within each layer of Government. The role of an efficient treasury is to determine clearly the department or level of Government responsible for spending including procurement and provide suitable ways to incentivise efficiency without creating more bureaucracy or centralisation.

In summary, The Scottish Exchequer should be driving the finance functions of Scottish government and its ministers, led by the Treasurer, with the task of raising and managing the public sector finances of Scotland.

BACKGROUND

HISTORY

The last Scottish Treasury was abolished in 1708, a year after the Acts of the Union. The Treasurer of Scotland, or to give him his full title, "Lord High Treasurer, Controller, Collector General and Treasurer of the New Augmentation," was responsible for all income from the Crown, Church and taxes, as well as for ensuring sufficient finance for the royal household and other public sector expenditure. In short, the Lord High Treasurer controlled the combined functions of raising funds and managing budgets, which is what would now be described as an "exchequer".

Since 1708 it has been HM Treasury that is responsible for developing and executing the UK government's public finance and economic policy across the UK including Scotland. The Treasury holds the public sector purse strings and as such has huge influence over other government departments as well as the devolved governments of Scotland, Wales and Northern Ireland, through its ability to allocate budgets.

The First Lord of the Treasury is the Prime Minister whilst the Second Lord of the Treasury is known as the Chancellor of the Exchequer or usually referred to as simply the Chancellor. It is the Chancellor who is responsible for running the Treasury together with the five other Ministers with responsibility for differing aspects of Treasury.

HM TREASURY

One could argue that the Treasury is both integrated and dysfunctional at the same time. The function of the Treasury has over time become broad; to create, manage and deliver the UK government's finance and economic policy. It formulates both the government's long-term economic policy as well as the short-term budgets. It negotiates with all the departments on expenditure and determines welfare payments. It is responsible for revenue collection principally through agencies such as HMRC. It is also responsible for regulation with the Bank of England and Financial Service Authority (FSA) reporting into the Treasury. The Treasury authorises the issue of money and Government debt. In short, the tentacles of the Treasury reach into every area of Government as well as UK economic control and regulation. Therefore, one could argue the Treasury is highly integrated.

However, at the same time the history of the Treasury has been one of merger between underlying government quangos that have often struggled to cope with the complexity of their history. For example the FSA was created from six underlying regulatory authorities including the Securities and Futures Authority, in turn an amalgamation of six more regulatory bodies. Or another example is HMRC, which was the merger of Customs and Excise and HM Inland Revenue. Often these amalgamations do not manage to integrate in a way that delivers a coherent service to the underlying user.

HOME RULE OPTION

Home Rule is a broad definition of how a subsidiary state or states defines the relationship within a principal state. In Chapter 1 it has been given a narrower definition by Sir Donald MacKay, however it can range from Fiscal Devolution, also known as Devolution Plus, where tax powers are transferred to a subsidiary state to cover most if not all of its responsibility for expenditure (such as in the US or Germany) to Fiscal Autonomy or Devolution Max where all tax powers are held by the subsidiary state and a payment is made to the larger state, such as the European Union. All of this can either be under devolved powers, where one state retains the right to change the constitution, or Federalism, where both principal and subsidiary states need to agree to a change in the constitution. This is different from Independence or Con-federalism where the subsidiary state becomes fully responsible for changes in the constitution.

This chapter assumes that the Home Rule option, whether devolved or federal, would leave responsibility for defence, foreign affairs, monetary policy, banking regulation, elements of welfare, borrowing and tax with the UK government, and that the rest, including the borrowing, tax setting and collecting powers needed to meet its expenditure, be passed to the Scottish government.

Home Rule would require most, but not all, of the treasury functions that would be required by an Independent state. The key areas such as banking regulation, including monitoring the Bank of England, and monetary policy, including determining interest rates, inflation targets and borrowing limits would still be determined by Treasury. However, Scotland would still need to have its proportionate level of influence over such areas as part of the UK.

A Scottish Exchequer would also require a restructuring of how the current Scottish government is organised, in particular how policy is created in Scotland within a new financial framework.

THE STRUCTURE OF SCOTTISH GOVERNMENT UNDER HOME RULE

How does one create a structure for a Scottish Exchequer without the department taking over too much control over the functioning of the rest of government whilst at the same time integrating the service it provides to both government and the public? The basic proposal in this chapter is for the Scottish government to have three departments in addition to public sector departments such as health, education, business development and rural development. These are a Scottish Exchequer, a Scottish Policy Unit and a Regulatory Department. These additional departments would replace the existing Finance and Justice departments.

The Scottish Exchequer would be responsible for government finance including all aspects of setting and collecting the taxes that are transferred to Scotland, raising debt, setting and agreeing department budgets as well as accounting and audit of government finances as published in the annual budget. Each of these aspects is discussed below.

Creation of policy would be driven through a newly formed Scottish Policy Unit, as described below, and all functions of regulation of financial, legal and accounting bodies be passed to the Regulation Department, an extension of the current Justice Department's portfolio.

THE SCOTTISH POLICY UNIT

One fundamental problem with the Treasury is that it is often in conflict on policy with other government departments and the Prime Minister's Office. The Treasury has a huge influence on all other ministerial departments to ensure they live within their budgets and this creates a natural and largely healthy tension to ensure efficiency within all parts of government to spend efficiently. However there is also a deeper reason for the tension that is less healthy. At present, economic policy is set by the Treasury and the Prime Minister's Strategy Unit (now part of the Cabinet Office) as well as each ministry also setting policy for its particular area of responsibility. All of these policy units will have economists determining what effect the impact of their policies will have on the economy and the efficiency of public services. One can understand the logic for this system but it has led to inefficiency and a lack of clear authority on long-term policy creation. This was particularly accentuated in Gordon Brown's years as Chancellor with the economic unit within the Treasury widening its sphere of influence into departmental policy of other ministries and controlling it through the budget process. In particular there was a culture of antagonism between the Prime Minister's Strategy Unit and the Economic Policy Unit of the Treasury.

The problem with the Treasury setting policy through the budget process is that it tends to predispose towards a short-term approach to government. The management of government finances is predominantly focused on the next year and does not tend to look beyond a three-year time horizon. The very nature of the Treasury means the type of civil servants who are attracted into the department are those that are risk adverse. This means that long-term reform proposals put forward by other ministries can be, and often are, squashed by the Treasury. Take for instance the policy of Foundation Hospitals supported by the Prime Minister's Strategy Unit but strongly resisted by Treasury. Another example would be the local income tax proposal by the Scottish government that Treasury opposed.

Therefore, in structuring a new Scottish Exchequer it is important to have clear lines on how policy is created and managed between the different departments of government. In order to create integrated policy across government, the economic policy unit should be separated into its own department that should also integrate the policy units in other parts of government ministries.

This new Scottish Policy Unit (SPU) would be responsible for setting the government's long-term strategy and monitoring the delivery of the strategy against both its results on the delivery of public services as well as its effect on the economy. The SPU should be directly responsible to the First Minister. The Scottish Exchequer should have direct input into the SPU as to the financial consequences of policy, including the macro-economic impact on the Scottish economy, but not control policy creation.

One of the problems with Westminster and now increasingly at Holyrood is the growth of the number of special advisers. It is partly due to a frustration amongst politicians about delivery on policies that they want from civil servants who are not accountable to the Ministers that they serve. A Scottish Cabinet Minister does not have responsibility for hiring the senior civil servants that report into the Minister. In Scotland senior civil servants are appointed by Westminster. Therefore in order to ensure that political policies are being promoted within government departments, ministers appoint special advisers to represent their political position.

The SPU is, particularly at the senior level, highly political; probably more so than any other government department. Therefore, in recognition of this it would make sense for the senior members of the SPU to be direct appointments by the Scottish government in power and subject to change with each new administration. The SPU would work with other departments to set the long term strategy of government, taking into account both the needs of each department but also the financial delivery, economic and social impact. This would integrate policy across all government and provide less potential contradictions between departmental policy and treasury policy. It would also remove the need for many of the special advisers as the party in power can ensure its long-term policies are being implemented through the SPU.

REGULATION DEPARTMENT

The formation of the FSA and the relationship between government and the banks has been one of the exacerbating factors that caused the financial crash in 2008. The creation of one regulatory unit and its aim of principle-led rather than rule-based regulation was sensible. However, the implementation of so many regulatory mergers created a dinosaur of an organisation that became predominantly rules based. This system of regulation was particularly unsuited to proactive management of systemic risk resulting in lack of controls and quick response to the financial over-leverage in 2007.

Scotland already has devolved powers for regulation of the accounting and legal professions. Monetary policy under Home Rule would remain the responsibility of the UK government and the Treasury would also need to have responsibility for regulation of the banks. However, all other professions including private client and institutional fund management, pensions, insurance and broking would be better served by a more local regulatory authority that can better assess risks on a principle rather than rules basis.

Therefore a new Regulatory Department would be responsible for the Scottish legal, accounting and tax professions as well as any financial regulation devolved to Scotland.

THE SCOTTISH EXCHEQUER

Removal of policy and regulation functions would leave the Scottish Exchequer with the functions of revenue collection, borrowing, budget allocation, welfare payments, government accounting and audit at a Scottish government level. The objective of the Scottish Exchequer is to create a balanced budget, matching expenditure with funding within borrowing limits.

The Scottish Exchequer would need to liaise both with the Treasury and the finance departments of each local authority to ensure that taxes set and collected at other levels of government were co-ordinated. It would also need to have a proportionate influence on monetary policy, such as setting interest rate levels and ensuring deficit controls and borrowing limits are agreed between different levels of government and properly enforced.

The process of revenue collection should be a highly automated service for taxpayers. The responsibility for ensuring that tax is collected should lie with the Scottish Exchequer although it might want to contract out part of the collection process, particularly the IT, to a third party. It should also build on the principles of self-assessment.

The Treasurer would be the head of the department directly accountable to the First Minister and Parliament for delivering a balanced budget.

THE FUNCTIONS OF THE SCOTTISH EXCHEQUER UNDER HOME RULE

SETTING TAX AND REVENUE

The objective in setting tax is to create a fair system, which helps create an environment for fiscal growth and is simple to administer. For the Scottish Exchequer to be able to create such a system it will need full control over a range of taxes so that it can use certain taxes as fiscal levers but adjust others to ensure a balanced budget. In addition it would make sense to transfer tax powers that can influence economic growth. The benefits of creating the right fiscal environment have already been described in Chapter 3 by David Simpson, and their relevance to the banking and financial sectors in Chapters 8 and 9 by John Kay and Keith Skeoch.

The current proposals under the Calman commission would make it hard for a Scottish Exchequer to create much in the way of fiscal levers or to simplify the current system of tax. The main proposal under Calman is to leave income tax collection and the setting of bands to Westminster and for Holyrood to have a fixed band of 10% that it can increase or decrease. This system will need to be constantly adjusted as thresholds change which will affect the budget formula and put the Treasury into constant negotiation with the Scottish Exchequer. Neither does it create a range of taxes to create a fiscal package suitable for economic growth as described in Chapter 5 by Drew Scott.

The opportunity for a Scottish Exchequer is to create a much simpler tax system particularly for personal taxes such as income tax, capital gains, inheritance tax and corporation tax removing many of the anomalies and attracting business growth. In addition the structure of Home Rule should transfer those revenues that particularly relate to business development in Scotland such as the revenue of the Crown Estate that is a key institution for developing tidal and wave energy. The Scottish Exchequer should be solely responsible for collection of taxes and payment of welfare for Holyrood, but would agree with the SPU how taxes might be made simpler and which taxes should be adjusted downwards to stimulate the economy and which taxes adjusted upwards to ensure a balanced budget.

TAX AND REVENUE COLLECTION

In 2005 the UK did the sensible thing and combined the two separate agencies of HM Customs and Exercise with the Inland Revenue to form HMRC. However, this process could go much further and a Scottish Exchequer could ensure that all revenue responsibility came under its direct control. The HMRC is responsible for about 84% of all revenue raised by Westminster. The merger of the different functions was budgeted to reduce staff by 12,500 (14%) and costs by 8% and in 2011 there was a further reduction of 12,500 staff. However the merger has not been without huge integration problems.

It would be most efficient if a Scottish Exchequer were responsible for 100% of all revenue raised directly within the department. Certain functions for the collection of revenue could be raised under contracts with third parties. One huge advantage Scotland has in this respect is that it starts from a clean sheet in creating a tax revenue collection department and can use the benefit of IT created in other countries.

Each tax payer, whether corporate or individual should have a unique tax code, mostly logically one's existing National Insurance number, that is cross referenced across all the system (including benefits) to ensure that tax collection is both efficient and fair. This will be particularly important for income tax to establish residency tests to pay Scottish income tax, and corporation tax to tax profits on the Scottish business of companies.

Tax help desks and on line guides should be provided to help the tax payer to easily address any problems that they encounter.

Wherever possible, tax should be deducted from source as this tends to meet much less resistance from the tax payer and is more efficient. Tax, benefits and bank accounts should be cross referenced so tax avoidance and benefit scams are reduced to a minimum.

GOVERNMENT DEBT

The Scottish Exchequer under Home Rule would need to agree with Treasury maximum debt levels that are acceptable for prudent management of the government finances and for the Scottish economy.

There are two key limits that should be applied on borrowing. The first is the level of government debt. There is a strong argument that the ratio of government debt should be measured against government income however it is more normal to look at it as a percentage of GDP. Gordon Brown whilst Chancellor introduced as one of his golden rules that government debt should not exceed 40% of GDP and as a rule it was a sensible proposal. However unfortunately the public sector deficit has allowed government debt to run away with itself and represented 76% of GDP in 2010 with the expectation that it will go over 100% GDP by 2013. It also does not include the unfunded element of public sector worker pensions and the liabilities to PPP, which are estimated to represent in the region of another 100% of GDP.

The second key limit is the total level of debt within a country against its GDP. The UK's total debt in 2008 against its GDP was 468%. This figure had more than doubled since 1990 and is higher than any other G20 country. A prudent figure for total level of debt would be 200% or less.

The SPU would be responsible for determining and agreeing with the Scottish Exchequer levels for government and total Scottish debt in collaboration with the UK Treasury so that Scotland has a prudent level of gearing both at a Scottish level and on a consolidated basis with the rest of the UK. Once these levels had been determined, the Scottish Exchequer would be responsible for managing the debt within these levels.

The Scottish Exchequer should have full freedom to issue notes, borrow, take on other forms of long-term liabilities, including provide guarantees, provided that the total extent of liabilities is properly registered as borrowing against its limits. The Scottish Exchequer should also be responsible for managing the term and refinancing of the debt.

CONTROL ON EXPENDITURE

The age-old problem with any government or for that matter any business is how to control departmental expenditure through the budget process. In most business however the product is very directly linked with the revenue. In government, revenue collection from the public whether through personal, sales, corporation or other taxes, is seen as remote from the public service that is provided to individuals and businesses.

One way to help remedy this is firstly to pass down responsibility and therefore fiscal powers to local government to meet the spending on services it is responsible for. Local government spending is about 20% of total public sector expenditure in Scotland excluding health and almost 40% if health is included. Passing revenue responsibility down to match responsibility for expenditure creates an important incentive for politicians to consider how best to provide quality and efficient public services to the public. In addition, it makes them more directly accountable.

ACCOUNTING AND AUDIT

Governments are good at legislating on how other organisations should prepare their accounts, with balance sheets, profit & loss accounts and cash flows which are independently audited, but are not prepared to eat their own cooking. The UK government's approach to accounting philosophy is little better than how one might run a corner shop. Governments such as New Zealand and Singapore have adopted a more corporate style of government accounting. In these countries the government does produce a balance sheet that at least attempts to value the national assets against the total government debt to get some measure of the country's net worth. Once this is established it then becomes possible to review how to work the asset base more efficiently. The balance sheet also provides a proper reference to off balance sheet liabilities such as unfunded pensions and long term contractual liabilities for instance on PPP projects.

Due to the current cash based approach to accounting, governments are not incentivised to recognise the difference between long term capital expenditure and the net balance of income and current expenditure to produce a current surplus/deficit. In order to address the deficit in the Europe Union and North America many countries adopt a policy that slashes a disproportionate amount of long-term capital expenditure at the expense of future growth. For instance the reduction in the Irish deficit reduced current expenditure by around 10% but capital expenditure by 50%. Reporting on Standard Accounting Practices (SAPs) that other UK organisations are required to do would force government to address the current account deficit, rather than the cash deficit, which tends to be cut through reducing long-term capital expenditure.

A Scottish Exchequer could demonstrate its commitment to transparent accounting practices by broadly adopting SAP accounting for its accounts and implementing an independent audit of its accounts. This would provide politicians with reliable information but also incentivise them to work their balance sheet and focus on balancing current expenditure with income rather than reducing capital expenditure. It would also provide the public with a much clearer picture of government finances giving greater openness and thereby making government more accountable.

ADDITIONAL FUNCTIONS OF TREASURY UNDER INDEPENDENCE

INDEPENDENCE

Under independence all government powers would be transferred to Scotland including full self-determination. This can be done with a joint sovereign or a change of sovereign or a move to a republic.

Therefore all powers including all tax powers would move to Scotland and a Scottish Exchequer would need to expand to cover all areas of tax, policy and regulation including banking regulation. Scotland would need its own central bank and would need to determine whether it stayed in Sterling and controlled its own monetary policy. The choice of currency has been set out in Chapter 7 by Andrew Hughes Hallett and this chapter looks at it from a treasury perspective and arrives at the same conclusion, that remaining part of Sterling is preferable to the other options.

MONETARY POLICY

Monetary policy is inextricably linked to currency and fiscal controls. As can be seen with the Euro, a single currency across a region with either significantly different fiscal controls or monetary policy will create tensions that exacerbate over time. Fixed currency rates have tended to fall apart unless accompanied by a united monetary policy. The UK has entered into a number of agreements to fix or peg its currencies, but eventually the pressure of differing economic pressures between members have forced participants to leave the schemes. The UK left the Gold Standard in 1931, left Bretton Woods in 1971 and left the Exchange Rate Mechanism (ERM) after only two years in 1992. As the Euro is currently finding out, single currency agreements can only work over time if the functions of monetary policy and fiscal controls are held centrally.

If Scotland were to gain Independence it is likely that it will remain part of Sterling given the level of economic integration between the two countries. The only feasible alternatives would be either to join the Euro or to establish the Scottish pound as a separate currency. The former of these two options would be difficult until the current problems have been sorted out and the consequences of the changes within Europe would mean ceding greater powers to Brussels, which is at odds with the notion of Independence. The logical decision for full Independence would therefore be to create a separate Scottish currency, however that would have a major impact on business in the British Isles.

Assuming Scotland stayed within Sterling, whether within the Union or Independence, then the functions of setting interest rates and issuing currency would be retained by the Bank of England, which has delegated authority from the Treasury. Scotland currently has representation on the

Monetary Policy Committee responsible for setting interest rates and issuing currency.

Monetary union only works with a sufficient degree of fiscal controls at the centre. Therefore, inflation targets for monetary policy, borrowing levels and fiscal controls should be set centrally to ensure harmony across the currency zone. Any Scottish Exchequer would need to fit into these arrangements. Borrowing limits and fiscal deficits would be required to be agreed by Treasury and the Scottish Exchequer.

If Scotland did become Independent as well as having its own currency then the roles of monetary policy, note issuance and fiscal controls would then fall to the Scottish Exchequer. This has various consequences in terms of central banks, currency issuance, government bonds that, although fascinating, go beyond the scope of this chapter. However, it would be the responsibility of a Scottish Exchequer to formulate how a Scottish currency would work.

SUMMARY OF RECOMMENDATIONS

1. There should be a Scottish Policy Unit and Regulation Department separate from the Scottish Exchequer and these departments would replace the Finance and Justice departments. The SPU would be responsible for setting the government's long-term strategy and monitoring the delivery of the strategy against both its results on the delivery of public services as well as its effect on the economy. The SPU should be directly responsible to the First Minister and the senior civil servants should be appointees made by each new government. The Regulation Department would be responsible for all regulation already devolved and subsequently transferred to Scotland.

2. A new Scottish Exchequer should have responsibility for both funding and expenditure directly and not through agencies. A review of all government tax, law and registration services should be undertaken as a first step. If work such as the collection or administration of a particular tax is transferred, it should be on an arm's length basis whether to another government, third or private sector organisation with a service contract for delivery. In addition, the Scottish Exchequer should be responsible for the delivery of any welfare payments that are transferred to Holyrood.

3. One of the aims of the Scottish Exchequer would be to simplify tax collection and benefits whilst improving the quality and availability of guidance. Local tax help centres should be established in each local authority area. Each individual and corporation should have a unique tax and benefits code.

4. The Scottish Exchequer should report financially under corporate style accounting standards providing an annual report each year with a full report of the finances for the previous two years including a balance sheet, profit & loss account and cash flow statement.

5. There should be a separate internal audit process to review and monitor the Scottish Exchequer.

6. The Scottish Exchequer should be responsible for setting broad budgets for the expenditure of governments departments. But departments should then take responsibility for spending to achieve their policy and operational objectives, which would limit ring fencing and detailed budget allocations within departments.

CONCLUSION

In reality, governments and their treasuries have little control over short-term fluctuations in their economies. In the long-term however there are certain actions that governments can take that will promote economic growth. Ensuring that there is proper long-term capital investment in areas such as transport, digital infrastructure and a skilled work force; ensuring that the state does not impose constrictive levels of taxation that impede commerce, and simplifying the processes of undertaking business such as obtaining planning permissions and reducing regulation. A new Scottish Exchequer together with a SPU has the opportunity to operate in a different way to the Treasury that will promote a far more co-ordinated, integrated approach to managing government finances and providing economic policy that is right for Scotland.

CHAPTER 12
WHAT DOES HOME RULE MEAN FOR ECONOMIC POLICY?

BY PROFESSOR SIR DONALD MACKAY

INTRODUCTION

This chapter is an exercise in the Scottish tradition of 'political economy,' this being a much more fruitful approach than the dry tedium and irrelevance which infects so much of modern 'economic science'. The classical economists, of whom the main British proponents were Adam Smith, David Ricardo, Thomas Malthus and John Stuart Mill, saw political economy as a discipline which analysed how economic, social, cultural and political issues and institutions interacted with each other and recognised that the interaction is not unidirectional. Thus, federalism is a very flexible construct but, at root, it must recognise that some government functions are best exercised at a federal level. These are extremely important but few in number. Once these are defined, the remaining functions are best left to the building blocks of the federation eg states or provinces or territories. In the UK, the federal level might be called, reflecting its history and its institutional structures, the United Kingdoms - the 's' being deliberate and it being understood that the kingdoms continue under the Crown. The obvious building blocks should be called the Home Countries, as long as it is understood that the latter is not a spelling mistake with a superfluous 'r'! The Canadian concept of 'territories' could encompass the Channel Islands, the Isle of Man etc.

In the last analysis a federal constitution is only workable if there is a widespread acceptance that some matters are better treated at a federal level, but others are more fruitfully treated below the federal level. Governments at both levels must understand that, while they are sovereign within their own defined jurisdictions, they each have a duty to have regard to the expectations and interests of the other governments and peoples within the federal union. Provided this fundamental understanding exists, then the federal arrangement should be capable of responding flexibly to meet the needs of the UK and those of the Home Countries. For example, there is a need to establish how these bodies should relate to the European Union, particularly in regard to direct discussions with the European Commission. These discussions should be normally headed by a UK minister, but there would certainly be cases where the minister should be a minister of one of the Home Countries. This would force the federal government and the Home Countries' governments to agree policy objectives more clearly and more openly, which would be a distinct improvement on past practice! To take one example, it is simply inconceivable that any Scottish government would have agreed to the implementation of the Common Fisheries Policy in the 1970s and this opposition would have been well founded. In what follows I have selected a number of areas, some of which are matters commonly treated as federal in nature and some of which may be treated more appropriately by allowing greater freedom of action below the federal level. The discussion covers defence, the currency, the banks, taxation and fiscal policy, economic structure, the business environment, planning and house building, and comparative advantage.

DEFENCE

To the classical economists the defence of the realm was regarded as "the first duty of the Sovereign". This has a modern echo in that the British armed forces owe their first allegiance to our Head of State - the Queen. This is a useful fiction as it reflects a reluctance to cede unfettered control of a standing military to any political party in charge of any parliament(s) at a particular moment of time. So, if foreign policy is the responsibility of a federal government, then the British military must be subject to the federal government under the Crown. If this, the most crucial of all federal responsibilities as it relates to matters of "life or death," is not a federal concept then there is no future for the Union.

The classical economists saw defence as the most evident example of a public good - that is, defence must give protection to all citizens and to all the federal territory. Before the fall of the Iron Curtain a nuclear missile would have tracked down to the UK from the north and, today, the Russian bear still tests the readiness of the UK's air defences from that same direction. Would any government be happy to leave the defence of its backdoor to a separate military which was not in NATO? Norway is a member of NATO because its history and offshore interests demonstrate her need to be a member of a wider European alliance. Scotland has the same needs and her military history demonstrates that the defence of the UK is likely to best be met by a unified response in a collective interest.

There are clear economies of scale in defence (excepting the Ministry of Defence!). This is most evident in the case of the nuclear deterrent based at Faslane, which could only be feasible for armed forces managed at a federal level. The location often creates problems for Scots, but they should console themselves that Faslane offers the best available operational base in the UK. There are alternatives, the most obvious being Barrow-in-Furness, but Faslane is the preferred option because it best meets the needs of MAD (Mutually Assured Destruction) strategy. With present technology, a submarine based nuclear deterrent maximises the ability to strike back at an aggressor if so required.

Faslane is the preferred location for a submarine based nuclear deterrent because it:

- provides quick access to the deep waters of the North Atlantic
- is remote from the major shipping lanes
- offers a base which is more easily secured against terrorist attack from land
- offers access to a suitable labour force and other shore based services

There are two further considerations which we should touch upon. First, an independent Scotland, even with very substantial expenditure, could not provide a credible defence policy except through a wider alliance. The current SNP policy is that Scotland would not be a member of NATO but would join the Organisation for Security and Cooperation in Europe. Its last military operations involved conflict between two members - Russia and Georgia! Second, the chief European contributors to NATO are the UK and France and it is not evident that a weakening of the UK's contribution would serve Scotland's best interests.

If only short term economic interests were considered then a case could be made for minimal defence expenditure by an independent Scotland with membership of NATO. Scotland would be turning her back on more than 300 years of military history, this including a battle for survival which threatened the continued existence of the Union within some of our own lifetimes. Any serious defence of a relatively small group of islands must be subject to a single high command capable of determining the deployment and use of the armed forces at home and abroad. All existing and new military bases would need to be federal government territory and freed from any planning regime which inhibited the uses made of that territory, access or the movement of troops and material. As far as the deployment of troops abroad, we must expect the history of our intervention in Iraq, and the apparently more successful intervention in Libya, should result in a recognition that the UK is no longer a world power and should only seek overseas deployment within a NATO led operation. In these circumstances continued membership of NATO appears appropriate.

CURRENCY

Andrew Hughes Hallett makes the essential point - 'adopting the currency and monetary policies of another country when the trade links are with a partner within the union,….is a recipe for disaster' and 'This speaks for staying with sterling on purely economic grounds, for as long as the UK remains Scotland's dominant trade and investment partner.' This is likely to remain the case for the foreseeable future. Both the history of the UK (and of Germany and Italy) and the unfolding economic and financial turmoil which is the Eurozone, offer strong support for the proposition that monetary unions should only be attempted where underlying economic, cultural and social considerations are strongly supportive.

In recent years I have attempted a rather haphazard straw poll of economists to ask whether they know the date at which the UK became an effective monetary union. Unsurprisingly, given the minimal importance now attached to the teaching of economic history, barely a handful had a clue. Adam Smith noted that, at the beginning of the 18th century, Scotland had been a poor country with few reserves of gold and silver. The development of joint stock banking and the wide acceptance of Scottish bank notes as a means of settling debts, allowed the banks to extend the necessary credit to finance rapid economic growth from 1750 onwards. The Scottish banks had their own spectacular failures but they were less frequent than in the rest of contemporary Europe. Smith noted that the banks had contributed a 'good deal' to the rapid growth of trade and industry, but all this happened before the Bank Charter Act of 1844. From that date (actually 1845 in Scotland) all new notes issued had to be backed on a one for one basis by Bank of England notes which were the only legal tender. Effectively, the Bank of England had acquired a monopoly of the note issue.

Monetary union came after the transformation which made the UK the leading economic power in Europe. Now consider the Eurozone. It was meant to promote economic convergence, but no attempt was made to provide the monetary and fiscal conditions which could have helped convergence triumph over divergence. Was it sensible to put in to a monetary union, Germany with a folk memory of the evils of hyperinflation and now the strongest manufacturing and trading country in Europe, and Greece, with a folk memory of high spending governments, a leaky tax collection system and a history of sovereign defaults? Greece is now faced with years of grinding austerity whether she remains in the Eurozone or defaults and exits.

The Irish might say, in their own case, that to exit from their own present difficulties they should not be starting from where they are now! The Irish government consistently pursued a prudent fiscal policy which was business friendly and was rewarded with the economic miracle of the "Celtic Tiger" - and, make no mistake, it was a miracle! Ireland has built a much stronger industrial and tradeable services base and still has a substantial trade surplus because of the rapid growth of these sectors from the 1980s. She was undone by the reckless behaviour of her banks. Portugal, Spain and Italy (and in the wings, Cypress and Belgium) all have their individual circumstances, but share a Eurozone which was conceived in haste but will be repented at the enforced leisure of many of its citizens.

It is not credible to consider that Scotland should seek membership of the Eurozone in preference to membership of the sterling area. Nor is it to play games by implying that Scotland should remain in the sterling area but should join the Eurozone when conditions are right. 'Never Say Never' said the Bond film with that famous Scottish actor but, for most politicians, never is a period beyond the next election. Those who consider that the Eurozone might suit Scotland better than continued membership of the sterling area are blind to the evidence that the UK monetary union has been a success. Monetary union in the UK came only after the transformation of the UK economy. It could only have been attempted successfully after that transformation and its operation has stood the test of time. Leave well alone.

BANKS

A monetary union has only one monetary policy and, if it not, it would not long survive as a monetary union. In the UK the central bank is the Bank of England and the name is not always favoured by Scots! It has been pressed on me that in a federal structure this is not an appropriate name but, then, the Bank of Britain is not an appropriate name either (the name does not encompass Northern Ireland). It seems sensible to continue with the name which reminds the world of the track record of a successful monetary union. Moreover, as the Bank of England was founded by a Scot, we should regard it as an example of the missionary work for which we have long been renowned and forget that the same person visited on Scotland the Darien Disaster! Sometimes we get it right and sometimes we get it wrong!

The Bank of England was founded in 1694 to finance an expensive war with France. One must hope that in today's world more useful activities could be pursued, given that in that period we tended to side with the French through the Auld Alliance. In modern day parlance the Bank of England's function was to oversee government borrowing and manage the national debt. In that sense it was the "government's bank" from its inception, but its monopoly power over the note issue came only in 1845 and its role as the "government's bank" was not formalised until it was nationalised by the Bank of England Act, 1946. Scotland would also need a central bank, but its role with the Scottish government would be restricted to the management of its debt as per the initial role of the Bank of England. As Drew Scott puts it, 'Scotland's government would also be responsible for financing any deficit of income over expenditure by issuing debt instruments and, subsequently, of managing its own domestic debt levels.' The debt instrument would be Scottish government bonds, but government borrowing would be conducted in accordance with the rules governing agreed debt limits. That is, the central bank in Scotland would not have the responsibility for managing monetary policy because that has to be a federal function. The central bank in Scotland would then be responsible for ensuring that Scottish government borrowed efficiently and should help secure fiscal stability at the macro UK level. These rules would need to be "Golden Rules," in practice as well as in name!

A central bank's authority depends on its present conduct and on its record and history. The latter aspects have been dented by the recent history of the "Scottish banks" but they were the heirs to a celebrated history. After all, it has long been said of Scots that they are good at looking after the money of other people because of a long experience of looking after their own! That is precisely the attitude which any central bank should nurture! The Scottish central bank should also be responsible for establishing the regulatory structure to ensure that all commercial and retail banks in Scotland operate independently of investment banking activities, that is, they should have different shareholders, depositors, managements and boards; and should not engage in a process which transfers their capital to investment banking activities.

The governance and management of a Scottish central bank must be seen as assisting the Scottish government to manage its debt within a framework of agreed rules and procedures. Like Caesar's wife, the Governor must be beyond reproach. This means that the Governor should not be a politician or strongly associated with any political party. Again, the central bank's physical presence is a visible signal of its importance and prestige. So it could be called the Central Bank of Scotland (the Lord Lyon permitting) and would have to be a nationalised institution. It should be located in full view of the inhabitants in the main financial centre of Scotland and two sites seem to meet this criterion best -the building at the top of The Mound (which should only be chosen if a price can be agreed with its present owner) or the building on Calton Hill which once housed the Royal High School. The physical setting would recall the echoes of Scotland's long history of banking. Either building could co-locate the Scottish Futures Trust and the Audit Office. The former has the responsibility to deliver value for money across all public infrastructure investment and the latter is tasked to consider how public sector bodies can make more effective use of public funds. Co-location would better ensure that their combined efforts could assist in framing their strategies so that a more secure base is established to ensure macro stability and micro efficiency in the use of public funds.

As "manufacturers of money," clearing banks, often called commercial and retail banks, are a critically important component of the financial sector. Scottish banks enjoyed a deserved reputation for being cautious, but that caution was allied to a history of innovation in banking best practice. The Scottish banks lost their way when they succumbed to the notion that they could successfully manage financial conglomerates (often called universal banks) which embrace a very wide range of activities within the same institution. In these circumstances, a chief executive needs a split personality and one of those personalities will become dominant - think Dr Jekyll and Mr Hyde! In the case of the Scottish banks the wittiest illustration of the new dominance of universal banking, is the answer to the question 'Who was the odd man out amongst Terry Wogan and the two chairman and two chief executives of the Royal Bank of Scotland (RBS) and Halifax Bank of Scotland (HBOS).' The answer is Terry Wogan because he was the only one to have passed his bankers' exams!

As John Kay puts it…'clashes of culture and conflicts of interests: contagion within (financial) institutions has meant that failures in relatively small parts of their operations have jeopardised the survival of the entire company. The government guaranteed retail deposit base has been used as collateral for speculative trading in wholesale financial markets.' Both the UK and the US government have misunderstood the lesson of the 1930s. The stock market crash on Wall Street led to a wave of retail bank failures in the US and a catastrophic fall in the domestic money supply. As a consequence, a government guarantee of bank deposits was intended to safeguard banks engaged in commercial and retail activities. It is not the function of the government to underwrite the far riskier activities of investment banking within a universal bank who use the government guaranteed retail deposit base 'as collateral for speculative trading in wholesale financial markets'. To use the American idiom - in a clash between Main Street and Wall Street the government must only be on the side of Main Street which is dependent on commercial and retail banking. Investment banking must fend for itself - it is entitled to its profits if risk and reward are managed appropriately, but if they are not then investment bankers are on their own.

The 2007-2008 crash demonstrates, yet again, that a recession originating in the financial sector commonly results in a sharper and more prolonged fall in real income than a recession originating in, say, manufacturing. "Managerial capitalism" is nowhere more dangerous than in banking. This is an outcome where the senior executives of a business run it in their own interest, rather than in the interest of their private shareholders and retail depositors. In the UK there is systemic agency risk as most banking shares are held by financial institutions whose senior executives have similar attitudes to the senior executives of banks. Over some 15 years the ratio of senior executive to median reward has increased hugely, as has the ratio of senior executive return and shareholder return. Historically, commercial and retail banks pyramided credit on a broad base of cash and liquid assets, with a narrow taper of the riskier assets at the top of the pyramid. In the financial conglomerates which came to characterise the banking sector, the dominant investment banking culture resulted in massive leveraging, creative off balance sheet accounting, wholesale lending and trading in packages of "assets" with the hope that if things did go wrong the package would explode in someone else's ownership. The largest banks were considered "too big to fail," but given any sensible definition of the word "fail" that is precisely what some of them did. The government passed the parcel to the British taxpayer as it exploded.

Andrew Hughes Hallett argues that 'a properly functioning banking system with reliable credit/lending channels is an essential component in any monetary regime…..(and this)…implies a local banking system, and a hand in its regulation, will be needed to make monetary policy effective.' John Kay also sees the structure of banking as the key issue. Recent history should convince us of one conclusion - that it is not safe to attempt to contain two very different cultures and practices within the same business. In Scotland's case its fundamental requirement in banking is to ensure that commercial and retail banks operating in Scotland should be separate institutions from investment banks. That is, a licence to operate such a bank in Scotland should ensure that its capital, its depositors and operation should be separate from investment banks - that means really separate and not "protected" by ring fencing, firewalls and the rest of management speak. And if ever we needed yet another lesson it has been provided by the news that UBS has suffered another substantial loss through unauthorised trading in exchange traded funds (EFTs). This follows on from the Swiss government bailing out, at a very great cost, UBS trading in asset-based securities only four years ago. So the regulator is the guardian of the structure of commercial and retail banking in Scotland. The outcome in Scotland would be a handful of boutique investment banks which is what is actually needed. If London wishes to keep or attract more investment banking of the "thundering herd" variety, then they should be free to do so. But watch out for the china shops!

TAXATION AND FISCAL POLICY

The American colonists believed that there should be no taxation without representation and the founders of the Scottish Parliament that there should be representation without taxation. Thus Holyrood is funded by a block grant from Westminster. It has the power to vary the standard rate of income tax by 3p in the pound but has chosen not to use it. This is wise as the costs of tax collection would be high and any increase in tax revenue would almost certainly result in a corresponding reduction in the block grant. Public expenditure per capita on devolved functions in Scotland is high relative to the English average and is higher than can be justified by the best single measure of need (income per capita). The same outcome is evident for the other devolved UK administrations and even for London – where the "justification" is that high local wage and salaries make the costs of public sector provision very high! There are major difficulties with this funding approach. As with quangos, those responsible for the Scottish budget are under pressure to spend all of the block grant - an underspend is taken to indicate that need has been less than the finance provided by the block grant. This favours programmes where annual expenditure is easier to predict and the bias is compounded by the inability of the Scottish government to borrow to fund capital expenditure. The chief victim is public expenditure on infrastructure projects - the area where the longer term needs of the Scottish economy are least well met.

The case for full fiscal responsibility rests on the following considerations. First, if the Scottish Parliament is not responsible for raising taxation to cover government expenditure in and on behalf of Scotland, then it is always going to press for a larger block grant. Second, the present system favours programmes which produce short-run political benefits, rather than those which promote long term economic development. Third, the UK is a highly centralised economy and while each UK government declares it is in favour of more localism, its deeds fall far short of these words. Thus, the UK is only one of two countries in Europe in which the central government sets and collects more than 90% of public sector taxes - the other country is Greece. Somehow I don't find this comforting! Fourth, there is a strong secular trend toward government expenditure and revenue increasing as a percentage of national income. Fifth, there is an increasing feeling that if the powers of the Scottish Parliament are to be extended, and this is the present position of all the parties represented at Holyrood, then a greater part of devolved expenditure should be funded by taxes levied on persons and activities resident in Scotland. Full fiscal responsibility simply takes the final step, so that a Scottish Parliament would be solely responsible for raising its own taxation and there would be no needs transfer from Westminster to Holyrood.

The logic of full fiscal responsibility is that a Scottish government might be better able to implement an economic policy appropriate to Scottish conditions, indeed this can be stated more strongly. Full fiscal responsibility means that the Scottish government will have the direct responsibility for establishing a fiscal framework which promotes long run economic growth - as Bill Clinton's campaign slogan put it, 'it's the economy, stupid'. Any Home Rule arrangement would presumably require that Scotland would have to accept a fair share (population based) of UK national debt and meet a similar share of federal government expenditure on foreign affairs, defence and any other federal activities. To manage the inherited debt effectively a Scottish government would have to have the ability to borrow but this would have to be on a macro basis consistent with the RUK. A Scottish government would be likely to take the view that the share of oil and gas tax revenues accruing to Scotland from the North Sea should be based on the Geneva Shelf Convention as applied to the littoral North Sea states. In this circumstance full fiscal responsibility would require the Scottish government to be responsible for licensing, planning and taxation and there would be a Scottish Crown Estate, presumably located within a Scottish Exchequer as proposed by Ben Thomson.

It is often suggested that Scotland should emulate the low corporation tax rate of Ireland as this was a critical element in the birth of the Celtic Tiger. Of course, the Celtic tiger is now facing a major recession but that was not caused by fiscal irresponsibility but, instead, by the reckless policies pursued by the banking system in Ireland. Yet, while a low corporation tax regime would help developed industry and traded services based in Scotland, the very success of the first mover make it inconceivable that a similar low corporation tax rate for Scotland would be regarded as acceptable competition within the UK or the EU. If it were, then any RUK (Rest of the UK) government would follow the Scottish corporate tax rate down. A more sensible policy would seem to be that the Scottish government should determine that corporate tax levels, except for new starts and small businesses, should match those in the RUK and that their future path, where downward, should match that of the Coalition government. A major consideration behind this is that the accountancy profession believes that the tax authorities throughout the UK, faced with different corporate tax levels and more complexity, would face major problems in tax shifting. Limiting this would substantially raise the costs to business of demonstrating compliance. There is an additional problem in that a significantly lower tax rate in Scotland might well result in a substantial shift of the brass plates of larger businesses (mostly the larger incorporated businesses) without this leading to a significant geographical shift of employment and income creation.

Full fiscal responsibility must mean that the Scottish government should have the freedom to develop its own tax system. It would not be sensible to create change and complexity for their own sake but the Scottish government must learn that lesson for itself. What it must understand immediately, however, is that there will have to be a macroeconomic balance between taxation and revenue which is reasonably consistent with that for the RUK. After all, we have a vivid example at hand of the manner in which irresponsible fiscal policies in a small part (2%) of the Eurozone (Greece) have destabilised the Eurozone itself. In a UK context, Scotland would have a much greater weight and an added responsibility to strike an appropriate fiscal balance.

This requires effective oversight of political behaviour rather than, simply, warm words. This was meant to be provided by the Office for Budget Responsibility and the person appointed to the post of head had all the required personal qualities and professional experience necessary for this task. However, the OBR seems to be regarded as providing an improved economic forecasting unit for HM Treasury and little else. What was required was that the economic policies pursued by the UK government applied the "Golden Rules" which were meant to end "boom and bust" in our lifetimes. However, the policies followed trashed the "Golden Rules" comprehensively. For example, the timing of the trade cycle was altered to suit a political rather than an economic agenda, there was an attempt to conflate government expenditure with investment when much of it represented consumption, and there were some spectacular examples of off balance sheet accounting in PFI and the treatment of public sector pensions.

Full fiscal responsibility implies there must be a Scottish Exchequer and its assumptions, rules and procedures must be subject to a regular annual review by, say, an Office for Fiscal Responsibility, placed before the relevant Scottish Parliament committee. The reporting structure must ensure that the assumptions, rules and procedures underlying fiscal policy are subject to the light of day. Consideration should be given to the OBR and OFR with the latter reporting annually to the appropriate committee of the Scottish Parliament. The objective is not to ensure that a Scottish government and a UK government should have exactly the same fiscal policies but to recognise that in an economy sharing the same monetary system there would have to be some 'Golden Rules'. Of course, we have the unfortunate example of such rules in the recent past but that was not because the rules themselves were inappropriate but that the politicians who formulated them had no intention of abiding by them. Oversight, transparency and full reporting to parliament are required so that the "Golden Rules" are observed.

ECONOMIC STRUCTURE

Arguably the most influential UK economic text of the 1970s (Bacon and Eltis, Britain's Economic Problem: Too Few Producers) began with a quote from Adam Smith:

'Great nations are never impoverished by private, though they sometimes are by public prodigality and misconduct. The whole, or almost the whole public revenue, is in most countries employed in maintaining unproductive hands….Such people, as they themselves produce nothing, are all maintained by the produce of other men's labour.'

It can be fairly argued that this reasoning led Smith to his greatest error, that labour was the only source of value. Smith, it has been said, 'loaded Marx's gun for him.' But no reader of Smith could overlook his general thesis that the dynamic of a market economy was critical to economic progress and that an overbearing state was often the root cause of economic waste and failure. This notion, that the macroeconomic balance of the economy, specifically the relative weight of the market and non-market sectors, was central to the 'Bacon and Eltis thesis'. The market sector produces goods and services for sale and the non-market sector is tax financed. Bacon and Eltis argued that, in the 1970s, the non-market sector had simply got too big and that this "crowded out" market activity resulting in slower growth, cost push inflation and a deteriorating balance of trade.

Unfortunately the policy errors of the 1970s were repeated in the period from 2000, leading to a large expansion of non-market activities, an increasingly imbalanced economy and eventually a financial crisis and the most severe recession since the 1930s. The 'Bacon and Eltis thesis' has particular relevance to Scotland and, indeed, to the poor economic performance of all the slow-growing regions of the UK economy. They are dominated by non-market activities. Public policy has supported these regions through enhanced public expenditure programmes which have increased non-market activity, while the market sector has continued its absolute and relative decline. The creation of a Scottish Parliament, funded through a block grant, simply entrenched the behaviour of the previous 30 years and aped the behaviour of many quangos - the budget is balanced by spending all the budget and then arguing for more. Lacking all the major instruments of economic policy no other behaviour should have been expected of Holyrood. The Westminster parties have also failed to grasp that there is no purpose in a devolved parliament unless it is capable of taking a different view as to how to discharge its social, including its economic responsibilities. The view that Westminster/Whitehall knows best no longer butters any parsnips in Scotland.

THE BUSINESS ENVIRONMENT

Bacon and Eltis argue that the macroeconomic structure of the economy is critical to understanding its long term economic performance, specifically that an economy with a small market and a large non-market component is likely to experience a lower rate of economic growth. Scotland is just such an economy, as is the North of England, South West England, Wales and Northern

Ireland. For this very reason, a Home Rule government should understand that measures which are considered appropriate for Scotland might well be appropriate for other regions and Scots should encourage emulation as being in their own and a wider common interest. In the discussion below I attempt to set out a framework which, if emulated, would encourage a substantial increase in market based activity both in Scotland and the other areas of the UK where market based activities are comparatively weak.

The remedy must lie in creating a business environment in which more people see a business career as their preferred choice. I will concentrate on the economic initiatives which might be most helpful, although it should be evident that success will also depend on educational, cultural and social changes which are supportive of and encourage the development of a business friendly environment. After all, we tend to think that we are rather like the Scandinavians. In terms of understanding the crucial importance of the small businesses we are not in the same league!

Now let me try and stitch together Adam Smith, Bacon and Eltis and David Bell to suggest that they all point in the same policy direction. The section on 'Economic structure' contains a quote from Adam Smith which implies that in the non-market sector you may find a lot of "jobsworths." As I point out in that section you can, and Adam Smith did, take this too far. He saw all services as unproductive and only the production of goods as useful. In a modern economy there is a need for the state to intervene and to ensure that it provides or finances an adequate supply of public services. But the problem is that the state may over -provide as well as under-provide and the former will lead to slower growth and other economic problems. These are compounded if government expenditure is tilted increasingly in the direction of present consumption against investment, as this impacts adversely on the long term rate of economic growth.

The structural problems we confront are well illustrated by David Bell's analysis. For example, '85% of the growth of 212.9 thousand jobs in Scotland between 1995 and 2008 can be attributed to three sectors - Health and Social Work, Education and Administration, Defence and Social Security. Most of these jobs are in the public sector. If such jobs are debt-financed... (and, in recent years, many of them have been)… this is clearly not a sustainable long-run growth path for the Scottish economy.' Again, in Scotland, 'production has become increasingly focused on the domestic market' and 'the decline in (employment) in the manufacturing sector has gone further and faster than almost everywhere else in Europe.' One might add that with some honourable exceptions, above all in financial services, Scotland also has noticeable weaknesses in tradeable services i.e. services which can be sold outside, as well as inside Scotland.

This is a case of what is now termed “crowding out”. That is, employment in the non-market sector funded by the taxpayer has been increasingly preferred to employment in the market sector. In a wholly market based economy prolonged differences in net advantages would be unusual. As Smith put it, ‘If in the same neighbourhood, there was any employment evidently any more or less advantageous than the rest, so many people would crowd into it in the one case, and so many would desert it in the other, that its advantages would soon return to the level of the other employments.’ But we live in an economy with a large and historically growing non-market sector funded by the taxpayer. The net advantages of labour are increasingly favourable to many in the non-market sector in terms of life time earnings, pensions, working conditions, security of employment, hours of work, holiday entitlements and the ability to turn up less frequently at work! These outcomes are less favourable for those employed in the market sector and, above all, for business start ups and small businesses. If we really wish to create a more dynamic and prosperous economy then we must develop policies which increase the incentive to and the net advantages from, employment in the market sector.

In the section on ‘Taxation and fiscal policy’ I suggested that the tax treatment of new businesses should be regarded as a special case. The relevant considerations are:

- as David Bell points out the ratio of business numbers to population is very low by UK and European standards
- this problem is evident in the main centre of population, the Central Belt, particularly in the west
- the life cycle of start - ups is much the same in Scotland as in the rest of the UK, with a high exit rate in the first two years and a similar pattern of subsequent survival and growth thereafter
- in short, the critical problem is that over many decades the birth rate of new businesses in Scotland has been low by UK standards

To put this in Adam Smith’s language, the net advantages of starting up or managing a small business are regarded by many as inferior to the net advantages of seeking employment elsewhere, particularly employment funded by the taxpayer. This employment structure is not likely to support a more rapidly growing economy and a shift toward a more market based economy will not be successful, unless we accept that the risk-reward ratio needs to move toward being more favourable for new starts and small businesses. I outline below some suggestions, it being understood that they indicate the nature of the changes required and, by no means, a detailed agenda.

Governments are not good at handling small businesses. Compared to the great majority of new and small businesses, a government is a large bureaucracy which expects the business to organise itself to meet the requirements of their departments, rather than that their departments should organise themselves to meet the requirements of business. For new start ups and small businesses this should be reversed - as far as is possible there should be a single door entry for all tax and regulatory matters, because the successful business will be lean on management time. The single door of entry should then coordinate the response of that department and other departments where necessary. The business is the customer and the government department should be the servant of the customer and must first serve his/her needs.

For the new start and small business existing processes are too complex and expensive of scarce management time. There are too many levels of compliance eg.

- PAYE, NHI, VAT, P11D, P45
- Corporation Tax
- Annual Returns and Annual Accounts
- Pension Schemes
- Employment Legislation
- Sickness Benefits
- Maternity/Paternity Benefits etc, etc

Complexity means that small businesses often have to pay for expert advice, especially accountants and lawyers. One possibility would be to create a new class of limited liability company, specifically designed for start - ups and businesses moving people from being a small trader or partnership. There may be a requirement for more than one category and many of the suggestions below could be tweaked to embrace a multi-tiered approach, but my own preference would be for a single, simple process which each company must observe. Provided these standards are met then any business can add as many bells and whistles as it likes, after all they will have to pay for the extra cost.

The characteristics of a new class of limited liability company should be:

- Their denomination (eg SCorp) is intended to advise that this is a limited company operating with reduced governance (the underlying principle being that applied to the Alternative Investment Market)
- Each business should have a unique tax/regulatory reference and any government response should be coordinated through a nominated individual/government department

- SCorps would be new starts in the first three years or ongoing businesses with less than £3 million in annual sales and less than 10 FTEs
- The VAT turnover threshold should be raised to £250,000 (presently £75,000)
- Corporation tax should be set to
  - 0% for the first three years of new start-ups
  - thereafter 10%
  - all complicated allowances should be abolished and standard depreciation rates applied
- A standard and drastically simplified Articles of Association should be adopted which a non-expert can understand
- Straightforward instructions on issuing shares should be provided
- SCorps should have no requirement to
  - file accounts
  - produce annual reports

It should be understood that these would be the legal minimum requirements to trade as a SCorp but they would be free to exceed those standards and the extent of disclosure if they so wish. If the customer wants to drive a Rolls Royce instead of a Skoda, then remember that the customer is always right!

PLANNING AND HOUSEBUILDING

The recovery of the UK economy from the Great Depression of 1929-32 was driven by the "new industries" and by one old industry in a "new" form - housebuilding. We have just been through another great boom and bust and, as always, the housebuilding industry has been part of that process. It is unlikely that we have yet reached the bottom of the recession in house prices in real terms but may be there by around 2014/5. Housebuilding is always going to be an activity which will be particularly subject to the business cycle but, unless we enjoy this process and are happy to bear the economic costs, we need to transform the planning process and ensure that it responds to market signals.

Sometime in the mid 1970s I got an informed and informal tutorial lesson from a man who had been born within the sound of the Bow Bells of London, but who had travelled the world in the navy and in the pursuit of his profession as an urban planner. He explained that the initial delineation of the green belt for Edinburgh had been done in rather a rush, so the residential areas were given one colour, the industrial areas another and the rest was coloured green, as it was to be the greenbelt. The map was reviewed from time to time and there was always some nibbling at the edges and, now and then, a more substantial excursion in to the greenbelt. But my instructor wondered what would happen if Edinburgh experienced a sustained increase in population. Would somebody have the vision to find and let loose the genius of a James Craig, the architect of the New Town, who enabled Edinburgh to escape the bounds imposed on its growth by the confines of the Old Town?

We are near that point now. The general Registry Office for Scotland has suggested that, on recent trends, the population of Edinburgh might increase by some 70,000 people by 2033. Now the Registry Office understands that extrapolation should not be a substitute for thinking and that such an increase in population will only be possible if we provide the housebuilding industry with an effective planning framework. What these projections demonstrate is that Edinburgh has the opportunity to grow quickly but can only do so if it anticipates the opportunity and creates a policy framework which encourages sustainable development. A failure to do this will lead us back to the familiar cycle of slow response, inadequate housing provision, rising prices and, consequently, a housing downturn. Borrowing from the wisdom of our forefathers, the city has to expand from the confines imposed by the green belt with the intention of housing a substantial proportion of the increased population to the west of the city, to create the Green Town, as a place to live, work and enjoy.

This is an occasion on which, as suggested in Chapter 1, we should "out-English the English," read the Draft National Planning Policy Framework for England and consider how it might apply to our own condition. It is said to replace 1,300 pages of planning rules by text of 52 pages. I am not able to verify the arithmetic underlying this statement but it is certainly a pleasure to read having just emerged from enduring 'The Government Economic Strategy' for Scotland, which says nothing of note in 99 pages. The English document is clear as to its intentions and expresses the major issues succinctly. It states a presumption in favour of sustainable development but its planning framework will be fiercely resisted in the Home Counties at which it is mainly aimed.

The essential problem is that the south east of England is one of the most densely populated areas in the world. Its population continues to rise rapidly and the successive governments have succumbed to the notion that a continuing contraction of our industrial sector can be ignored so long as our financial sector keeps on expanding. An efficient financial sector with the global reach of the UK, and particularly London, is a huge asset but continuous expansion of this sector with continuing decline in our industrial sector is not likely to provide a stable long term base for an economy with 60+ million people. An advanced economy also needs to be able to make many things and not only a small number of things in the same place. The difficulty is that London is displaying increasing signs of the diseconomies of agglomeration and, if one attempts to minimise this by decanting more people, businesses and houses into the rural areas of the south east, then the existing population may well fear that this process will seriously diminish their quality of life.

What are these diseconomies of agglomeration? The most obvious is that London is an extremely expensive place to live and provide public services. Hence, the estimate for planned public expenditure per capita in London is marginally ahead of Scotland and only just behind that for Northern Ireland. On this measure Scotland has been better treated than the other regions except London and the latter has been given a similar settlement because it has high wage and salary costs i.e. it has serious agglomeration diseconomies. In the short run this is perfectly understandable, even acceptable, but in the long run this is not a sensible response, as it is neither acceptable nor efficient. The UK is one of the most centralised economies in the world and a major cause of this is that it is very centralised in political terms. Rather like Tokyo it is extremely common to find functions, which could easily be managed remotely, continuing to operate in high cost locations, particularly those in the non-market economy. Think of the BBC as an enduring example of how a non-market institution can survive with a top-heavy management structure and a high fixed cost base!

The rural areas in the home counties will fiercely resist the National Planning Policy Framework for England fearing that if they give an inch the government will take a mile. But the cities of the North of England could well benefit from a policy which was less London-centric, as would Scotland, Wales and Northern Ireland. There are some policy proposals which would be suitable for the Scottish condition, some of which should be relevant for the slower growing regions of the UK. These include:

- the New Homes Bonus, introduced in England, matches the funds raised from additional council taxes on new properties and properties brought back in to use, for a period of six years, with additional funding for affordable homes; this is likely to be most effective in areas where there is some spare infrastructure capacity and where the project does not introduce large population centres eg in smaller developments in cities or small towns.

- a recent Audit Scotland report has found that the cost of planning has increased at a time when planning applications have been falling: this is useful corroboration of Parkinson's Law, that work expands to fill the time available and appears to be an affliction of Scottish local authorities; a detailed study in the mid-1990s found that function by function Scottish local authorities had a higher number of employees per thousand population than their English counterparts.

- the planning system has target timetables for dealing with the stages of the planning process but the Scottish local authorities have a poor record of meeting these timetables; as the "name and blame scenario" has conspicuously failed it is time to add financial benefits and penalties to separate the sheep from the goats.
- planners need to get away from basing housing targets and locations mainly on measures of "need" and understand how to interpret price signals which indicate what people want; for example, returning to the Edinburgh scene, the relative price movements of flats and family housing indicate that there is significantly greater unmet market demand for family housing; there is also a general shortage of modern housebuilding as Edinburgh accounts for 9% of all Scottish households but only 6% of new housing.

So, returning to the Green Town concept, we need: to establish a James Craig Award (say £5million) for the best master plan for the Green Town, take this through the required planning process and, on the understanding that this represents the sustainable development and living environment which the city and wider economy requires, establish a programme for public and private investment to complete the Green Town by 2030.

COMPETITIVE ADVANTAGE IN ACTION

So how would the classical economists have approached economic policy? They would have begun from the notion that each economy should identify and build on its comparative (both natural and acquired) advantages and then trade with other economies to their mutual advantage. Adam Smith had the initial idea, observing that Scotland could grow very good grapes but that they would be much more expensive than grapes grown in France. Ricardo formulated the underlying idea more elegantly and precisely. Each country should concentrate on where its comparative advantages lie and trade accordingly. Today, the benefits of freer trade have been hugely increased because new technologies have shrunk the cost of distance and the time period in which new technologies are applied in new settings. Classical economists also recognised that economic life is shaped by a shared history, a shared culture and proximity and, yet, that economic welfare is unlikely to be enhanced by larger, more centralised governments and bureaucracies. Coordinated monetary and fiscal policies are necessary requirements for short term stability but, for long term growth, economic policy needs to be directed toward those activities in which a country has clear comparative advantage.

Scotland has a number of important industries which have demonstrated the importance of exploiting natural and acquired advantages. Two examples are the food and drink industry and financial services. The former has developed the supply chain upstream in to fish farming and downstream in to processing and production resulting in substantially expanded output and exports of high quality products - and this from the land which still has a reputation for the deep fried Mars bar! The latter, as Keith Skeoch demonstrates, has shown remarkable resilience despite the implosion of the "Scottish banks" and remains what he calls a 'core sector.' Both sectors share one characteristic which will be necessary for the comparative advantage of the embryo sector I discuss below. That is, these sectors were driven by people who understood that success would only accrue from consistent long term policies aimed at enhancing natural and acquired advantages. This is a concept which economists often find difficult to manage. Most of the financial models we employ heavily discount the future so that after a 10 year period all future returns are heavily discounted. However, if you take the view that each generation has a duty to act as if we are tenants of a world with a full repairing lease, then we have an obligation to leave to our succeeding generations a world which offers an economic, social, built and natural environment at least as good as we have enjoyed. Here our best guide is to look to our natural and acquired advantages and frame our policies accordingly.

In the 1977 publication, I recalled that in the early 1970s it was 'remarked, jocularly, that the amount of assistance each area received from the (then) EEC regional development fund should be positively related to its length of coastline divided by its population …..(and)… that this very principle is a central feature of the Geneva Continental Shelf Convention.' If this principle had been applied to Scotland and England as it was to the other littoral states of the North Sea, then, as Alex Kemp demonstrates, the great bulk of the taxation revenues would have accrued to a Scottish government. Economists have no unique insight in to what might have been an equitable division but they could see that a higher real price of oil was always likely to create political tensions because it would produce high economic rents; that is, a return over that required to induce businesses to undertake exploration and production. In a highly centralised tax system this meant that these rents could accrue to the UK exchequer, while in a federal system (eg Canada) a substantial part of these economic rents would accrue to the producing regions.

The UK is now well past the point of maximum tax revenue from oil production and it is extremely unlikely that we shall ever return to the very high tax revenues which accrued in the 1980s. However, as Alex Kemp observes, it is probable that North Sea production will continue at a higher level than previously expected. The floor to the price of oil will be under significant upward pressure from the fast growing developing economies with large populations and an energy intensive economic structure. If the future real price of oil is around $100 dollars per barrel, then tax revenues to a Scottish government could be in the range $5-10 billion per annum. At this point we need to consider the notion that each generation should act as a tenant abiding by the terms of a full repairing lease. In energy policy we have failed lamentably in this regard and we now need to consider how this could be put right.

Suppose we take the concept of “peak oil” and adapt the underlying concept to UK domestic energy production:

- peak coal was in 1913 and is now less than 5% of that level
- peak electricity from nuclear was in 1998 and is now less than half that level
- peak oil was in 1994 and is now 45% of that level
- peak gas was in 2000 and is now some two-thirds of that level

By the early 1970s the UK energy deficit was, in financial terms, some 5% of GDP before rapidly rising North Sea oil and gas production turned this in to a surplus of 2% by the mid-1980s. As of today, the value of our energy deficit accounts for the bulk of our trade gap and is growing rapidly. This has been the most obvious failure of economic policy in our modern history.

Consider how UK oil and gas production is treated for national income accounting purposes. An increase in output is taken as an addition to national income, which it is in the period in which it occurs. That income can be used to finance current consumption or invested to provide future energy production. As oil and gas reserves are a depletable resource, the income of future generations will be adversely affected unless some part of that present increase in income is invested in developing alternative sources of energy. The core to any sustainable energy policy lies in a comparative (the word comparative is critical) advantage in nuclear power in England and Wales and a comparative (and absolute) advantage in renewables in Scotland. Scotland can produce nuclear power as cheaply as England and Wales but not more cheaply and, politically, any increase in nuclear stations would be even more contentious in Scotland than in England and Wales. A classical economist might have wondered why the Scots were so obtuse about nuclear power but, ever the realists, they would have drawn the obvious conclusion - Scotland should specialise in developing its comparative advantage in renewables and trade electricity through the market mechanisms already established for that purpose.

Before proceeding further let us consider the resource base of renewables. The length of coastline and population size are critical variables, as is the wind climate. The position of Scotland between the North Atlantic and the North Sea provides strong and predictable tidal streams, above all in the Pentland Firth. And tidal power will be important for the islands to the north and the west. Contrast this with Germany. Scotland has a good wind climate with 6,158 miles of coastline and 5 million people, against the German equivalents of 1,493 miles and 83 million. The potential for renewable production in Scotland is much greater relative to its population than that of any other country in north west Europe and, possibly, in Europe as a whole. Scotland has acquired upstream advantages in servicing North Sea oil and gas production and what is currently missing from the supply chain can be supplied by existing businesses and/or from inward investment.

The development of Scotland's renewable resources will require substantial up-front investment and a higher real price of energy compared with our historical experience. But success will require consistency of purpose which has been conspicuously absent from energy policy these last 30 years - the intentions have been admirable, the delivery awful. Quite simply we have been coasting along because of the comfort blanket provided by North Sea oil and gas. For example, the UK was comparatively early in developing nuclear power for commercial purposes but never managed to emulate the clarity and coherence of French policy in terms of establishing and proving the preferred technology, controlling construction costs, establishing an appropriate planning framework which set down clear national goals and a process for ensuring local support within that framework. I have the personal scars to prove this having laboured, without success, to persuade a succession of government agencies of the benefits which would accrue from learning from French experience in establishing a deep level repository for nuclear waste. Any future construction programme will have to depend heavily on imported technology (from France) but the costs of building new nuclear power stations will be extremely high unless the UK can adopt a much more focussed national and local planning framework for this process. On the basis of our historical record the time period for and costs of commissioning, constructing, operating, delivering, decommissioning and disposing of the nuclear waste will be much longer and the costs much higher than any present estimates.

The public debate on renewables has been stuck in a groove about wind power, and especially onshore wind farms, that debate failing to recognise that any substantial increased electricity production in the period to 2020 must depend largely on this source as, given its historic record, it is extremely unlikely that the UK government will be able to push through a major nuclear plant production programme within the required time frame. The Scottish government's targets are that onshore wind will reach a capacity to 7GW by

2020, offshore wind 6GW, hydro power and biomass 2GW and wave and tidal streams 1GW. Industry sources think these targets may be overoptimistic but not wildly so. They do not dispute the potential for rapid development or the determination of the Scottish government to drive this forward. The most important points are these:

- if there is a UK case for the development of more onshore and offshore wind farms in the UK then it is entirely sensible that a very large proportion of these should be based in Scotland - she has a clear natural advantage in the best wind resource and, in the case of offshore wind, a clear acquired advantage in the upstream and downstream industries which were developed to support North Sea oil and gas

- the "cherry in the cake" is hoped and expected to be wave and tidal streams to the north and west of the Scottish mainland, particularly offshore the Scottish islands - the potential is well established but the issue is whether we can develop the technology to harness this resource and the funding which will be required to finance the substantial public sector investment which will be required. Here again is a natural advantage which needs to be capitalised by our acquired advantage in marine and offshore engineering particularly.

Is there any evidence that the Scottish government has a joined up policy which can help deliver this policy? Let us consider what is happening instead of being fixated by the "motherhood and apple pie" statements which often pass for economic planning in the modern era. The objective is not to generate electricity to meet all of Scotland's energy needs domestically by 2020 but to produce, by that date, energy equivalent to Scottish consumption. Some electricity generated in Scotland would be transported via the national grid to the rest of the UK and Scotland would import some base load electricity from England. We know this because it is the only outcome which makes sense of the planned increase in the inter-connector capacity between Scotland and England. That capacity has increased from 0.8GW in 1990 to 2.8GW today and is expected to rise to 4.4GW by 2016. Beyond this the so-called "eastern and western bootstraps" are expected to increase inter-connector capacity to around 8GW by around 2020.

Renewable resources will produce energy at a much higher cost than hydrocarbons. Production and distribution is only feasible after heavy up front capital expenditure and there will be no economic rent which can be appropriated by higher taxation as was the case with North Sea oil. Instead, electricity prices can be expected to be above historic levels in real terms. While the main short term financial burden will fall on energy consumers, the stream of future North Sea tax revenue could be directed to help fund the additional public investment required to enhance the supply bases onshore, the transport infrastructure within and to the Highlands and Islands, and the national grid system.

Most ambitious of all is the North Sea grid, a project on which ten European countries have signed a memorandum of understanding. As far as the UK is concerned, any substantial investment, will not take place until it can be demonstrated that large volumes of electricity can be generated from wave and tidal stream power. The chief market for this will be north west Europe serviced by the proposed North Sea grid which will almost certainly require an important element of public sector funding. However, while the downstream distribution system will require very substantial new investment, it will also be able to service future electricity production from onshore and offshore wind production. Most important of all, the upstream supply chain on which renewable production will depend (eg major and forward supply bases, installation, operations and maintenance support, project management and engineering, cable laying, safety and maintenance) is largely in place as a result of the experience acquired in servicing North Sea oil and gas production.

As far as renewables are concerned the position today is not dissimilar to that which faced the nascent North Sea oil and gas industry in the late 1960s - the resource base was to prove much bigger than anyone had anticipated and its successful exploitation required massive technological gains to drive down costs. The same is true of renewables today except that we already know that the scale of the renewable potential is very large, we know that Scotland has the best renewable resource and we have the experience of building a supply chain which meets most of the major requirements of the supply chain which will service the renewables industry. Unfortunately we will not enjoy any stream of economic rents, as was the case for North Sea oil and gas production, and so we are unlikely to emulate Saudi Arabia in this regard! However, if the technology can be developed to harness tidal streams and wave power then the future tax revenues from the North Sea appear sufficient for us yet to help put in place the necessary supply and delivery infrastructure. As a young engineer put it to me some four years ago, 'it is not a case of if, it is a case of when.' Others may consider this overoptimistic but those businesses which were instrumental in helping to meet the formidable challenges of North Sea oil and gas production appear to agree with the young engineer.

Now while Scotland will not be a Saudi Arabia in terms of earning high economic rents, there are a number of upstream and downstream businesses which could add value to the supply of electricity and a supply of pure water substantially in excess of domestic consumption requirements - as to the latter, Scotland accounts for the great bulk of the UK's fresh water supply, reflecting the fact that the average loch contains much more water than the average lake. This is evidently renewable - we have a lot of rain - and is another natural advantage to add to the mix.

Often the natural or acquired resource has to be taken to locations close to the final consumer to ensure the lowest cost base. However, electricity cannot be readily stored, the distribution system requires heavy capital expenditure and power losses are some 2.5% in transmission and some 3-10% in distribution. With fresh water these problems are magnified many times over because of its high weight to value ratio and the fact that our natural reservoirs (lochs) are located in very sparsely populated areas So we should now consider what upstream and downstream activities might be established close to the source of this enhanced electricity and fresh water supply. That is, if the mountain will not go to Mohammed, then Mohammed must go to the mountain. So, in the downstream and upstream supply chain, where might the opportunities lie to add value to these comparative advantages? I have consulted widely with colleagues and friends and would emphasise that while these judgements are informed, they will include a number of "fliers" which will probably not work as well as a number which are very likely to do so. But remember the health warning!

UPSTREAM

It is estimated that a 20MW offshore wind farm would have a capital cost of million some £3million per installed MW. Proximity to the farm would be a major advantage if allied to a natural harbour and good port and industrial facilities. During installation the major cost items which could be captured by such a port would be turbines (some 50% of costs), foundations (15%), vessels (12) and cables (4%). During operation, expenditure would be much lower but there would be an ongoing expenditure on operating costs which might be captured at the same location.

The best natural harbour on the east coast north of the Caledonian Canal, with an assured electricity supply, an excellent natural harbour, port facilities and a rail head, is the Cromarty Firth. You must understand that my mother and father were educated at Cromarty School and I received most of my primary school education there. But the ideas set out below have been discussed with someone who understands the potential of the Cromarty Firth better than I do, so I believe that my head may be in synch with my heart!

The Cromarty Firth has the natural location advantages for large scale, marine based operations - a deep, safe harbour and adjacent flat land, and a labour supply with the mix of skills and experience. The primary requirement for an Enterprise is to marine operations, is to reopen the Nigg yard which formerly produced steel jackets for the North Sea fields. The production facilities now required would be for fabrication (turbine, towers etc) and for offshore and specialised marine operations. With respect to North Sea oil and gas, the market opportunities are oil related repairs and refurbishment.

DOWNSTREAM

The other obvious site which should form part of this Enterprise Zone is Invergordon, formerly an EZ with its anchor project an aluminium smelter. There is a warning here and it is that the smelter eventually failed because it was an electricity intensive project whose viability depended on delivering competitively priced electricity to the site. This did not prove possible and, eventually, the smelter closed. As 'The Proclaimers' put it, 'Invergordon no more!' Yet, if wave and, above all tidal stream electricity can be delivered at a competitive price to the Cromarty Firth, then there are a number of electricity intensive industries which could readily be accommodated at Invergordon and add value to this stream of electricity.

Here there are a number of possibilities which fall in to two broad categories. First, industries which are electricity intensive and whose products have a high weight to value ratio which will require good ports based on the east coast to export mainly to Europe and a rail head to transport goods south to the UK market possibly routing through Eurocentral. Their proximity in relation to substantial and more reliable supplies of electricity suggest that these possibilities could not be realised earlier than 2020 - batteries, especially car batteries; pulp and paper production; chloro-alkali chemicals,cement and arc furnace steel. And the second category is electricity intensive and weightless including cloud computing (which would utilise another natural advantage - a cold climate) and back office and call centre activities.

These activities require 24/7 electricity supply at a competitive price and if this cannot be assured then we should not start down this path. However, By 2020 we will know whether we can harness the tidal stream in the Pentland Firth and if energy intensive industries are established in the area of the Cromarty Firth then adding value there would save a lot of capital in further extending the capacity of the national grid.

A clear spatial plan and a funding programme for the public infrastructure will be required. Although we are presently stuck with the label of Enterprise Zones (which, too often have resulted in simply shifting the deckchairs on the Titanic) we should be clear that the purpose is to implement a strategy like that underlying the 1961 Toothill Report. This was to widen our industrial and our trading service base and to support the growth and marketing of goods and services through public investment in the built environment and the transport infrastructure. On this basis, two other production, transport and communication hubs are worth serious consideration, as their establishment as Enterprise Zones would facilitate the expansion of Scotland's industrial and tradeable services base - Edinburgh and Glasgow Airports specialising in high value to weight tradeable services and weightless services.

Let us be clear. The engineering and planning challenge will be formidable but, if renewable energy cannot be exploited with the formidable natural and acquired advantages of Scotland, then it is unlikely to be viable anywhere else in Europe. Consider the factors which should determine the mix of non-renewable and renewable energy sources. The opportunity cost of non-renewables is their cost relative to renewables. If the non-renewable base is large relative to future demand then it is unlikely that substantial investment in renewables will be required. However, non-renewables have a finite life and, as they diminish in scale, their cost of extraction is likely to rise relative to that of renewables. We are in an unprecedented period in the world economy in that the growth rate of economies with very large populations is outstripping that of the richer, more mature economies and the former will be heavily dependent on non-renewable resources. In this circumstance would it be sensible to bet the house on an energy policy which is heavily dependent on non-renewable resources?

The above argument would be strengthened if future reliance on non-renewables resulted in substantial adverse externalities - the obvious candidate is global warming. However, the existing science on global warming is very unconvincing as to the certainty or timing of any impact. There is a case for appropriate action at a global level on prudential grounds but success would depend on the major economies adopting appropriate policies - what Scotland does will have little global impact. So the case for a Scottish government pressing ahead with renewables is (a) that Scotland has major advantages in terms of natural and acquired advantages (b) the Scottish government has a clear commitment and plan to develop renewables (c) on the historic evidence the UK energy policy stance is unconvincing and appears likely to result in a rapidly widening energy trade gap until at least 2020 (d) the skills and expertise developed in the North Sea are directly relevant to renewables (e) there will be a need for public capital investment in the early stages of development, but it surely makes sense to use some substantial part of future North Sea oil and gas tax revenues for this purpose. Sometimes we economists have to stop obsessing as to what will happen this week or year and do what the classical economists would have done - look to our competitive advantage and decide what is appropriate to meet the terms of our full repairing lease.

CONCLUSIONS

In the 1977 publication I suggested economics could not and should not be the decisive factor in determining constitutional questions. Such questions can only be answered by the electorate based on a clear understanding of what terms such as devolution max, home rule, independence lite and independence imply. As Shakespeare put it 'Aye, there's the rub' as each of these terms seem to mean very different things to different people and, sometimes, very different things for the same person! So what do I mean by these terms and, in particular, what do I mean by Home Rule?

Administrative devolution dates back to the creation of the Scottish Office in 1885 and the so-called "democratic deficit" (meaning a lack of direct Scottish parliamentary oversight) was not addressed until the creation of the Scottish Parliament in 1999. The Scottish Parliament is a subsidiary body as the legislation specifically asserts the continuing right of the UK Parliament to legislate on Scottish matters. Devolution max (or Devo Max) would simply mean more of the same. As far as economic policy is concerned, the parliament would still be funded mainly through a block grant which is hardly going to emphasise the need to act responsibly and with the longer term in mind. The polar extreme is independence but, in the modern world, economic independence is seldom very polarised, except for the basket cases such as Burma, North Korea and a raft of underdeveloped countries with poor natural resource endowments and marked institutional weaknesses. Given Scotland's economic, social and political history I find it difficult to see why it would advantage Scotland to turn her back on the Union, instead of seeking to reform it to serve better the needs of Scotland and the UK in the modern world. This leaves the two intermediate cases of Home Rule and independence lite (or Indy Lite). As far as I can see, these are similar concepts in all important regards, though I must state an instinctive dislike of modern abbreviations such as Devo Max and Indy Lite. Hence I choose the name, Home Rule, which embraces the basic idea which lies within Indy Lite, but which resonates to a long history. Remember 'he who knows no history is condemned to repeat it' and if we do repeat it we may be revisiting a difficult period at the end of the 19th century.

Yet we still have a dilemma in that some authorities often appear somewhat confused as to what Home Rule means. Wikipedia tells us that in the UK it 'has traditionally referred to self-government, or devolution or independence, of constituent nations (namely Scotland, Wales and Northern Ireland)….' It is not entirely clear as to why England is excluded from the list of constituent nations but this Anglo eccentricity may explain why Wikipedia also believes, erroneously, that home rule is not compatible with federalism. Irish home rulers saw an Irish Parliament as being within the UK and the Scottish Covenant sought 'in all loyalty to the Crown and within the framework of the United Kingdom, to do everything in our power to secure for Scotland a parliament with adequate legislative authority in Scottish affairs.'

Federalism shares powers between a federal government and national, regional or state governments. The division of powers is defined in a written constitution and entrenched for both levels - that is, it cannot be changed by simple legislation, so that each government is sovereign or independent within its defined area of competence. In the UK this could be a federal government and Home Rule governments for the RUK and Scotland, or a federal government and Home Rule governments for the four Home Countries. Either would resolve the paradox first posed by Tam Dalyell and named by Enoch Powell as the 'West Lothian Question', in that in both cases there would be no Scottish representation except at the federal level. Critics tend to consider this as asymmetric (which it is) implying it would be unstable. However, most federations are asymmetric but stable, except for Belgium which is not asymmetric but never seems to have a stable government. The evidence suggests that federalism is a flexible concept which can provide stable government. There is only one guarantor - that the constituent parties may wish some independence of action but understand that on certain critical matters the Union will be greater than the sum of its parts. Like most successful partnerships a fruitful federation is built on vive la difference and an understanding that the whole is often greater than the sum of the parts.

And how should these constitutional questions be settled? Certainly not by economists, as the economic issues cannot be seen clearly enough to be decisive. Nor by constitutional experts who claim to be able to interpret a constitution which is famously unwritten. So let me appeal to recent and more ancient history. The 1997 referendum on devolution was put to a Scottish electorate and another constitutional question relating to Scotland must be put to the same electorate. Whatever choice or choices are put, their implications must be clearly set out to allow an informed judgement to be made. That judgement must be final, as for the Scottish people, the essential constitutional principle is written down. In the Declaration of Arbroath the most iconic of Scottish kings was informed that he only exercised power lent to him by his people and that they reserved the power to take it back if they so required. Hence, the ultimate sovereign power rests with the people and not any parliamentary body. If the Scottish Parliament is responsible for framing the question(s) then they must be clear as to what terms like devolution, Home Rule and independence mean and the terms on which these will be negotiated. If the subsequent vote is decisive then, whatever it is, it must be put in place on the terms indicated. So all views must be freely expressed, all options clearly explained and the electorate must know that whatever alternative they vote for will be negotiated and settled in the manner this has been put before them. The people are sovereign. So, if there is a case for Home Rule, then the question has to be put clearly before the people and they will expect their answer to be binding on all the parliaments involved. As the Americans say, “go figure”!

SCOTLAND'S ECONOMIC FUTURE
EDITED BY PROFESSOR SIR DONALD MACKAY

Reform Scotland is an independent think tank, committed to informing and influencing the public policy debate in Scotland. As such, it is delighted to publish 'Scotland's Economic Future' which is edited by Professor Sir Donald MacKay.

This book examines various issues surrounding Scotland's economic future and how that relates to the debate surrounding the constitution. This issue is bound to dominate the next few years leading up to the independence referendum and this will be a very important contribution to the debate about Scotland's future with a cast of distinguished contributors.

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