The attached is a submission by the Royal Society of Edinburgh to the Economy, Energy and Tourism Committee’s Inquiry into Scotland’s Economic Future Post 2014. This submission pulls together the key points raised at a dedicated series of events on Scotland’s future organised by the RSE and the British Academy, entitled Scotland and the UK: Enlightening the Constitutional Debate. This series of events has assembled expert speakers to discuss topics with relevance to this Inquiry, including Taxation and Spending, Currency, Banking and Financial Services, The Real Economy, and Welfare and Public Services. The views expressed in this submission are distilled from the reports of these events, and do not represent the views of the RSE or its Fellowship. The full reports of these events can be viewed at www.royalsoced.org.uk

The views expressed in this paper are not those of the Royal Society of Edinburgh. They are a distillation and summary of views expressed by acknowledged experts who were brought together by the Society and the British Academy at a series of seminars under the general title, Scotland and the UK: Enlightening the Constitutional Debate. These seminars took place during 2013.

Monetary Policy and Fiscal Policy
At two events held in April and July, experts met to discuss Currency, Banking and Financial Services, and Taxation and Spending, and how these might look after the Referendum on Scotland’s constitutional future. The main points raised by speakers at these two events are outlined below.

Currency
The point was made that monetary policy issues have an overlap with fiscal issues. This overlap was discussed in relation to the currency options available to an independent Scotland. The option favoured by the Scottish Government in their White Paper on Independence is for Scotland to retain a monetary union with the rest of the UK. It was observed that this option is not a straightforward one; it is now a conventionally held political and market position that it is difficult, if not impossible, to achieve a stable currency union unless it is accompanied by banking or fiscal union, or at least a step towards these. Although the US may be taken as a counterexample to this, with each state having its own treasury, it was observed that in the US the absence of fiscal union is counterbalanced by the existence of a strong political union within a federal system, neither of which would exist in the case of a newly independent Scotland and the rest of the UK. On this basis it was suggested that negotiating an acceptable monetary union between Scotland and the rest of the UK would be difficult, and that any such negotiation would have to take into account the asymmetry between Scotland and the UK. Scotland would account for only 8.5% of the monetary union, and the rest of the UK would therefore expect oversight of Scotland’s economic policies. It may be difficult therefore for Scotland to negotiate a monetary union on acceptable terms.
Impacts on fiscal policy

It was observed that wherever there is a monetary union, there is greater pressure on fiscal policy. Within a currency union there is a need for greater fiscal stabilisation, and this stabilisation could prove difficult to achieve in an independent Scotland when the fiscal transfers that currently exist between Scotland and the UK are lost. The asymmetry between Scotland and the UK also leads to a much greater asymmetry of risk between the two nations. The Scottish Government position is that in a monetary union with the UK, the Bank of England would provide lender-of-last resort facilities to an independent Scotland, on the basis that the Bank of England is a UK institution which serves the whole of the UK. The point was made that under a formal monetary union, particularly given the risk of asymmetric shock, the Scottish Government would accept monetary policy created at the sterling level, and agreements on fiscal aggregates. This would give the UK Government a lot of control over fiscal issues in Scotland. The point was made that small, open economies do not tend to have much scope for creating their own monetary policy, but tend to take this from elsewhere (for example, the Eurozone). Neither do they set their own financial regulation; this is done at the international level.

It was suggested that the fiscal constraints on an independent Scotland would be considerably tighter than they are under the Scotland Act 2012. The risk would be even greater if negotiations for a monetary union were to fail and Scotland’s debt repudiated. This is because the danger of the market pushing up interest rates under these circumstances would be considerable. It was suggested that, on this basis, the risk of the flight of Scottish assets into the rest of the UK would be high, and to counter this, the Scottish Government would have to run a very tight ship with regard to fiscal policy. Independence, it was argued, implies the need for tight fiscal policy.

Borrowing and debt

A further implication of the asymmetric risk between Scotland and the UK is that the interest rate the Scottish Government would have to pay on their share of the debt would be higher than the interest rate paid by the rest of the UK. It was suggested that if RBS and Halifax Bank of Scotland (HBOS) were to relocate their headquarters to the UK following independence, their borrowing costs would not be affected very much. It was observed that in this scenario Scotland’s pension funds and asset management would not be affected much, although it was conceded that there might be a possibility that Scottish borrowers became subject to a credit risk, particularly if Scotland were to have an independent currency. If Scotland does retain sterling however, this risk is smaller, and while there would likely be a marginal increase in interest rates, but this would not be enough to make a huge difference.

The point was made that whatever currency option an independent Scotland takes, Scotland’s debt would, at least initially until credibility has been established, attract a higher interest rate. In order to keep the interest rate within bounds, Scotland would need to have much tighter fiscal policy. Given that the UK Government has agreed to continue to honour existing debt, an agreement will have to be put in place to ensure that Scotland makes its contribution towards these debt servicing costs.

Read the full report on Currency, Banking and Financial Services: http://www.royalsoced.org.uk/cms/files/events/reports/2012-2013/currency-banking.pdf
**Taxation and spending**

At a discussion on Taxation and Spending after the Referendum, it was observed that at an aggregate level Scotland has enjoyed consistently high levels of public spending, around 10% higher *per capita* than the rest of the UK, with relatively similar onshore tax revenues. This means that the gap between onshore tax and spend is bigger in Scotland than in the rest of the UK. This analysis does not give the full picture however, since it does not take into account North Sea Oil revenues. North Sea Oil revenue offsets Scotland’s higher public spending to some degree, and this fact demonstrates the importance of the North Sea Oil revenue to Scotland’s fiscal situation and to the debate on Scotland’s fiscal future. The volatility of North Sea Oil revenues was referred to, and it was suggested that while this volatility can be managed quite well at the UK level - where North Sea Oil receipts account for between 1% and 2% of overall receipts - at the Scottish level, where these receipts constitute around 10% to 20% of overall receipts, the impact of this volatility is likely to be much greater.

The Scotland Act 2012 represents the biggest transfer of fiscal powers in 300 years, giving the Scottish Government powers over income tax, stamp-duty-land tax and land-fill tax, along with borrowing powers which enable it to vary the levels of tax and spending in Scotland. It was also observed that the Scotland Act 2012 will increase the amount of self-financing in the Scottish budget, from around 15% as things stand at the moment to around one-third once the powers afforded by the Act are fully introduced, from 2016-17. Enacting these new powers is merely the start; the process of fiscal devolution represents new and complex territory for both the Scottish and UK Governments. A feature of almost all developed economies is that they will experience long-term fiscal pressures of one form or another. The most common of these are an ageing population and declining resources, both of which apply to the UK and Scotland. It was suggested that these pressures are likely to be felt more acutely in Scotland than by the UK as a whole. Two pressures particularly likely to impact upon Scotland in the future were identified: a decline in oil and gas revenues: and a high ratio of people aged 65 and over to people aged between 15 and 65.

It is important when looking at Scottish independence to examine not only Scotland’s potential fiscal position in comparison with the UK, but also to examine what the absolute fiscal positions of Scotland and the UK will be, both at the referendum and beyond. The annual deficit in 2014 will still be very large, and will continue to be significant in 2016 and 2017 and the context of the short-term fiscal situation in the UK will be one of dramatic spending cuts. Levels of outstanding national debt will continue to rise through 2014, 2015 and 2016. High levels of national debt will put the UK and Scotland in the top bracket of OECD countries on levels of debt, and will make Scotland in particular one of the only countries of its size and population to have such high debt.

The relative fiscal context of Scotland is, in the short-term, very straightforward, with Scottish income and tax per head being very similar to the rest of the UK and spending per head around 10% to 12% higher. Ignoring North Sea Oil revenues the Scottish deficit is higher than that of the UK, and taking account of Oil revenues it is roughly the same, although volatility is increased. Given the impact of North Sea Oil
revenues, an important question going forward was highlighted as being what will happen to oil revenues in the short and medium term? If CPPR and OBR forecasts are correct, this will draw Scotland into a worse fiscal position than the rest of the UK over the next few years, although it was acknowledged that there is huge uncertainty around the future of oil revenues.

The question was posed as to what kind of fiscal architecture an independent Scotland might want to put in place; would Scotland, for example, want to put in place something like the OBR? A further question was posed around how an independent Scotland might account for volatile and diminishing oil revenues when thinking about what its fiscal rules ought to look like. It was suggested that cautious medium-term fiscal rules would remove oil revenues from the fiscal balance, so that over a protracted period a fiscal balance excluding oil revenues would be sought. This approach is a possible equivalent to building up an ‘oil fund’.

An independent Scotland would have many more tax choices. Scotland would be inheriting a tax system that is not optimal, and will have the opportunity to move towards a more rational and neutral tax system, should it so choose. It was suggested that there will be some questions in relation to the tax system which will be different for countries which are smaller and more open than the UK as a whole, for example:

- How to structure corporation tax – especially in a country which will remain very integrated with the rest of the UK;
- How to take account of cross border issues in indirect taxes, and;
- How to think about whether there are differences in the responsiveness of labour and capital to differential rates of income and corporation tax.

The example of the taxation of alcohol was raised. It was observed that Scotland has a policy of minimum pricing for alcohol rather than levying a higher tax on alcohol, and it was suggested that an independent Scotland would be able to tax alcohol as it chooses, subject to EU rules. It was further suggested that an independent Scotland would have many more choices available around spending; at present spending in Scotland is higher than the rest of the UK across every single devolved sector, not simply in relation to higher education, social welfare or health. Choices are available as to how Scotland manages its future spending.

Read the full report on Taxation and Spending after the Referendum: [http://www.royalsoced.org.uk/cms/files/events/reports/2012-2013/Tax_and_Spending.pdf](http://www.royalsoced.org.uk/cms/files/events/reports/2012-2013/Tax_and_Spending.pdf)

**Economic Focus**

At an event held in June, on the Real Economy, experts discussed aspects of Scotland’s economy besides banking and the financial services sector. The key points raised during this discussion are summarised below:

*Management of Natural Assets (including oil and gas)*
The energy sector is hugely important in Scotland in terms of investment activities, and in terms of the energy sector’s contribution through taxation and rents. The point
was made that Scotland faces a need to maintain a continuous flow of investment back into this sector, if it is to flourish. Energy nations must make a choice between using the benefits of the energy sector for enjoyment in the future, and consuming contemporaneously the revenue earned by the sector. The more that is consumed in the short-term, the lower the incomes that can be generated by the sector in the future will be. The major challenge is in getting the balance between these two options right. If investment is not being financed by the revenue from the sector itself, there will be a need for large inward flows of capital from outside. This means becoming extremely highly integrated with capital markets around the world. The consequence of this level of integration is that independent management of policy, for example monetary and fiscal policy, will be heavily constrained. The idea that Scotland’s energy sector will provide Scotland with the freedom to be independent may be correct in one sense, but this freedom may come at a very high cost to independence in another sense.

Scotland has a small, energy-dependent and relatively open economy. Economies of this kind tend to suffer enormously from volatility of prices. All energy prices have a tendency to extreme swings, which can be cyclical, or dependent upon external factors. The more reliant an economy is upon the energy sector the more likely it is to find itself squeezed if energy prices work adversely, and the greater the bonus will be in terms of revenue if they work positively. Spending this revenue has a consequence however, which is widely referred to as ‘Dutch Disease’. This is endemic in all energy dependent countries. The manifestation of this phenomenon is that in times of economic growth the prices of non-traded goods (goods made and consumed at home) are driven up by demand, meaning that the costs for other traded sectors (e.g. manufacturing) are higher than they would otherwise be. These sectors ultimately find themselves squeezed, the consequence being that in all energy dependent countries traded goods outside the energy sector get squeezed out and eventually die. In Scotland this is likely to have a huge impact because manufacturing industries account for a far larger proportion of employment in Scotland than the energy sector does.

It was suggested that finding a solution will pose a considerable challenge to an independent Scottish Government. One option would be to create a ‘sovereign wealth fund’ as Norway has done, funded by revenue from the energy sector. Norway’s sovereign wealth fund was started a long time ago, and Norway’s real wealth is not its sovereign wealth fund, but its publicly owned company, Stat Oil. Scotland would not be starting from this position: the state does not own the resources or the infrastructure of North Sea Oil, and even if the Scottish Government began receiving the rents from North Sea Oil, it has already committed to spending this money to finance public spending. The choice that would be faced by an independent Scotland is therefore between setting up and paying into a wealth fund, or continuing to pay for what is needed today out of the revenue of the energy sector. This is a choice which all energy-reliant economies must make. While Scotland’s energy is a great benefit, it is one that needs to be managed differently in the future.
**Labour market issues**

Tackling inequality has been a key theme of the constitutional debate, and it was suggested that inequality at the Scottish level cannot be tackled unless and until inequalities in the labour market are tackled.

The labour market is a complex entity. Recent statistics on the Scottish labour market have been reasonably positive relative to the rest of the UK, and the Scottish labour market is highly integrated with the rest of the UK. The Scottish labour market is lightly regulated, and has labour market institutions which are UK wide and/or UK affiliated. Trade union density in Scotland is higher than for the UK as a whole. In relation to the performance of the Scottish labour market, it has performed well since devolution, relative to the UK and by international standards. Scotland has maintained relatively high employment levels, but does suffer from long-standing regional unemployment as well as high levels of low-paid work and high levels of under-employment. Some of these, and other, negative labour market trends were apparent before the recession began in 2008, and these negative labour market trends will have to be addressed, especially if the aspirations for the Scottish economy of those who campaign for independence are to be achieved.

With regard to what Scottish independence might entail with regard to the labour market, it was suggested that it is difficult to discern a rationale for devolving labour markets under enhanced devolution, but that independence is an entirely different matter. It was suggested that a newly independent Scottish Government might want to do as little as possible to upset the levels of integration between Scottish and UK labour markets. On the other hand, it may wish to shift towards a model more aligned with small European nations, for example the Nordic nations to which Scotland often compares itself.

The Scottish Government has published its economic case for independence, which introduces into the debate some issues around the labour market. Within this document there are indications of a shift towards a system of centralised bargaining mechanisms, like those of the Nordic states. This would include mechanisms to formalise the relationship among Government, Employer Organisations and Employee Associations.

This proposal could have a profound impact on the Scottish economy and the labour market. The challenges involved in bringing about a shift towards centralised bargaining mechanisms are significant. Bargaining structures are part of the cultural and historic fabric of societies, and are therefore not easily changed by Government action. While the social and cultural conditions exist in Nordic states to allow social partnerships to flourish, the same is not true of Scotland, which has no recent history of successful centralised bargaining mechanisms. Social partnerships in Scotland are weak and the employer side of these partnerships is fragmented and unrepresentative. A report by Michael Heseltine was referred to, which stresses that the way employer organisations in the UK are set up is detrimental to the policy development process. Then report recommends establishing a mechanism closer to the European Chamber model. It was observed that the way Government in Scotland is set up is not conducive to social partnerships; there is a capacity issue, and the institutional infrastructure does not exist to support a move towards more formal styles of social partnerships.
Discussing next steps, it was suggested that there is not likely to be much consensus for reform of the current structure; the UK flexible labour market has very widespread political support and it was suggested that any initiative for heavier monitoring of social partnerships is likely to face strong opposition.

**Competition policy and regulation**

It was pointed out that at the UK level major structural change is already being observed, with the Office of Fair Trading and the Competition Commission being brought together to form the Competition and Markets Authority (CMA). The CMA has committed to having a presence in Scotland, which the Competition Commission has not, and given the increased levels of devolution across the UK, it will be crucial to take account of the policy differences between different regions. There are differences in policy in different regions of the UK, and these differences matter. It is crucial for all regulatory bodies to recognise these differences. There are difficulties that arise from working with so many separate policies, because many policies transcend the boundary between Scotland and the rest of the UK, and will transcend those boundaries at least for the first 10 years after the Scottish referendum, in the event of a ‘Yes’ vote. It was suggested that it would be neither efficient nor effective to undertake separate studies for the UK and Scotland. There are many instances when regulatory bodies are looking at distinct sectors, and the policies governing these largely apply across national and regional boundaries. In these cases there is a need for close cooperation and working by regulatory bodies across these boundaries.

It was suggested that Scotland can operate an independent regulatory regime very successfully, the example of Water Industry Commission for Scotland being demonstrative of this. A distinct Scottish water regulatory body was merited because Scotland has a distinct water industry. Whether a distinct Scottish regulator is needed for other sectors is not certain, if there is to be a single energy market operating across Scotland and the UK after a ‘Yes’ vote in the referendum, are separate regulatory bodies for Scotland and the rest of the UK warranted or desirable? A single regulator could work, provided it takes account of distinct regional policies. On the other hand, the existence of completely distinct energy markets in Scotland and the rest of the UK would warrant distinct regulatory bodies. There is a need to select an approach which makes sense for the individual circumstance.

It was suggested that the Scottish Government’s proposition is perfectly tenable: that – following a ‘Yes’ vote in the referendum’ regulatory functions are brought together under one body, which in the UK are carried out by diverse bodies. The UK is showing evidence of going down this route already by bringing the OFT and the Competition Commission together. This system can work, as indicated by New Zealand and the Netherlands; however there are always caveats as to how this works. There will be a need for a highly skilled and expensive staff to implement this system, comprising lawyers, accountants and economists, with genuine business experience. It would also be critical for any new regulatory body to be seen as wholly independent of government. Regulatory policy would need to be established by the government, but the implementation of these policies needs to be entirely separate.
Such a body would need to have links with the UK and with the EU, because a lot of policies will transcend the national level, and links with the EU will be critical.

Under Scottish independence or increased devolution there will be an increasing need to look at the Scottish dimension when implementing regulatory policy. There will be a need to work in close harmony with the UK and under the constraints of EU policy. Greater efficiency might be achieved through aggregation, but the costs of this should not be underestimated, and finally, no market is perfect, some intervention is always needed, but this needs to be well argued and carefully implemented.

Read the full report on the Real Economy: www.royalsoced.org.uk/cms/files/events/reports/2012-2013/The-Real-Economy.pdf

Welfare and Equality

At an event held in November 2013, expert speakers met to discuss Welfare and Public Services in the context of Scotland’s constitutional future. The main points made at this event are summarised below.

Social security and welfare payments
Speakers at this event discussed the options an independent Scotland might have for welfare reform. It was observed that whilst in the long term radical change to the welfare system might be a possibility for Scotland; in the short to medium term this is less likely to be an option. Due to Scotland’s macroeconomic issues, including Scotland’s share of the national debt, significant expansion to Scotland’s welfare budget in the short-to-medium term is difficult to envisage. The per capita share of Scotland’s debt is likely to peak at around £106 billion in 2016-17, assuming the same kind of trajectory as the UK as a whole. That figure would represent around 86% of Scotland’s GDP at that time. Significant reform is difficult if there is not an expanding budget, as the ‘gainers’ cannot compensate the ‘losers’. If significant reform were to be a possibility, a key consideration would be political support. There is substantial support in Scotland for welfare decisions to be taken in Holyrood; however Scots do not appear to hold much hope that more would be spent on welfare if Scotland did become independent. There is no evidence to suggest that Scotland as a country is more disposed to the welfare state than the rest of the UK, with recent survey evidence quoted as indicating that 55% of Scots are in favour of unemployed people being made to work for their benefits. There has been some hostility towards the welfare state in the UK, particularly amongst young people. A suggestion was made that a possible way of restoring confidence in the welfare state would be to strengthen the contributory principle.

A speaker at this event highlighted the difference between the UK and other European countries with regard to their approaches to welfare. It was suggested that these differences could provide a foundation for thinking about first principles for welfare in an independent Scotland. This could be helpful in three ways: by shifting the focus of welfare away from poverty and towards the notion of welfare as a form of insurance for all people paying into the system; by creating the opportunity to look at other countries and the way they do things; and by shifting the debate towards a
focus on reciprocity, a notion which is currently very alien in the UK, but which would better engage high income groups in the system.

Another speaker suggested that the Referendum on Scotland’s future will provide the opportunity for Scotland to consider welfare reform more compassionately, and to place greater focus on preventative spend and taking an anticipatory, rather than a reactive, approach to welfare. It was suggested that the current welfare system is failing, because formal social security arrangements have traditionally served men more favourably than women. This is in part due to the direct relationship between insurance-based benefits and the labour market, but is also due to the failure of policy to recognise the diverse role of women as wives, mothers, carers and workers. The constitutional debate was thought to provide a platform for discussing these issues.

It was suggested that the whole concept of the welfare state is currently restructuring, so that in the future we will not have anything which looks like the current welfare state. The existing welfare state is based upon the ‘old’ social risks posed by the traditional model of the labour market; a model which is now out of date. There is now acknowledgement of a new category of social risks, which the welfare state needs to be insured against. There is a general consensus that it does not make sense to pay people to remain out of work, and linking welfare into the work of labour markets is a broad international trend. The observation was made that the welfare state is changing its territorial scale, with combinations of social risks occurring differently in different areas. Many anti-poverty initiatives are therefore territorial, and often the best place to link welfare and labour markets is at the local and regional level. The problem is that if you detach this from the national welfare system, you lose the coherent approach to tackling these issues. The scale of welfare is shifting and becoming more territorialised, and it is no longer adequate to suggest that the nation state is the sole locus of social solidarity, or even the most appropriate. Smaller countries tend to be better at social solidarity. The constitutional debate could be used to think about how we can use social solidarity to address the new issues in the welfare debate.

Poverty and income distribution
In the UK there are high levels of relative income poverty, and the percentage of people living below the poverty line has not been lower than 20% since the late 1980s. This flat-line hides a huge amount of movement; for example pension credit and better pensions for older people have improved their circumstances. For many single pensioners and lone parents, their prospects have been improved, and as both groups tend to be predominantly women, this has gone some way towards addressing gender imbalances in poverty.

Poverty is not a single issue problem, and it was observed that the lack of breadth taken in policy approaches to tackling poverty is problematic. There is no compelling vision of what a poverty free Scotland would look like, and a clear destination is essential in designing strategies to address poverty. Current legislation, such as the Child Poverty Act, do not meet this need, and provide only an abstract set of quantitative targets, rather than a clearly defined destination. A further flaw in current strategy to address poverty was thought to be the fact that there is no long-term, cross-party support for anti-poverty policy. This means that each time there is a new
Government they try to reinvent the wheel, and do not take forward the good work of the previous administration. What is more, interactions between policy areas are not good. Policies with relevance for poverty are not coordinated because they are managed by different Government departments, and a dynamic life course approach does not feature at the heart of current policy strategy.

Read the full report on Welfare and Public Services: http://www.royalsoced.org.uk/1068_WelfareandPublicServices.html

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