The Scottish Parliament
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Official Report

ECONOMY, ENERGY AND TOURISM COMMITTEE

Wednesday 5 March 2014

Session 4

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ECONOMY, ENERGY AND TOURISM COMMITTEE
6th Meeting 2014, Session 4

CONVENER

*Murdo Fraser (Mid Scotland and Fife) (Con)

DEPUTY CONVENER

*Dennis Robertson (Aberdeenshire West) (SNP)

COMMITTEE MEMBERS

*Christian Allard (North East Scotland) (SNP)
*Richard Baker (North East Scotland) (Lab)
*Marco Biagi (Edinburgh Central) (SNP)
*Chic Brodie (South Scotland) (SNP)
*Alison Johnstone (Lothian) (Green)
*Mike MacKenzie (Highlands and Islands) (SNP)
*Margaret McDougall (West Scotland) (Lab)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Dr Angus Armstrong (National Institute of Economic and Social Research)
Professor Jo Armstrong (Centre for Public Policy for Regions)
Professor David Bell (University of Stirling)
Crawford Beveridge (Fiscal Commission Working Group)
Professor Andrew Hughes Hallett (Fiscal Commission Working Group)
Professor Charlie Jeffery (University of Edinburgh)
Paul Johnson (Institute for Fiscal Studies)
Joan McAlpine (South Scotland) (SNP) (Committee Substitute)
Professor David Simpson

CLERK TO THE COMMITTEE

Stephen Imrie

LOCATION

Committee Room 4

Scottish Parliament

Economy, Energy and Tourism Committee

Wednesday 5 March 2014

[The Convener *opened the meeting at 09:15*]

Interests

The Convener (Murdo Fraser): Good morning, ladies and gentlemen, and welcome to the Economy, Energy and Tourism Committee's sixth meeting in 2014. I welcome our witnesses, whom I will introduce in a moment. I remind everyone to turn off or at least turn to silent all mobile phones and other electronic devices, so that they do not interfere with the committee's work. We have apologies from Dennis Robertson, who is unwell, unfortunately. We are joined by Joan McAlpine as his substitute.

Agenda item 1 is a declaration of interests. I welcome Richard Baker as a new member of the committee and I pay tribute to Hanzala Malik, who has departed for pastures new. I thank Hanzala for his contribution to the committee's work in the previous months and wish him well in his new position.

I ask Richard Baker to declare any interests that are relevant to the committee's work.

Richard Baker (North East Scotland) (Lab): I declare an interest as a member of the trade union Unite.

Scotland's Economic Future Post-2014

09:16

The Convener: Item 2 is the continuation of our inquiry into Scotland's economic future post-2014. I welcome the first panel of witnesses. We are joined by Dr Angus Armstrong, who is from the National Institute of Economic and Social Research and is a fellow of the Economic and Social Research Council's future of the United Kingdom and Scotland programme; by a familiar face—that of Professor Jo Armstrong, who is an independent economist and researcher at the Centre for Public Policy for Regions, University of Glasgow; and by Paul Johnson, who is the director of the Institute for Fiscal Studies.

As I said to the witnesses privately before the meeting, we are a little short on time. We hope to get through the first panel by about 10.30, so I ask members to be concise and to the point in their questioning. Answers that are as concise as possible would be helpful. I ask members to direct their questions to a particular witness. If a witness would like to respond to a question that was addressed to someone else or make a comment, I ask them to catch my eye and I will bring them in as time permits.

I will start with a question to Dr Angus Armstrong. We have two Armstrongs; perhaps I had better use first names—otherwise, I will get confused. Currency options have become an important issue in the debate. The First Minister said last week that it would be in the overwhelming interest of the rest of the UK to enter a currency union with Scotland. Is that a fair analysis of the position? Is the decision that George Osborne and his colleagues took to rule out a currency union rational?

Dr Angus Armstrong (National Institute of Economic and Social Research): Good morning, members. You are completely correct to say that the currency issue is at the centre of the debate and, in my opinion, it will remain there. It is central to many of the economic issues.

As for developments in the past couple of weeks, we must be careful about terms. The white paper proposed a particular form of currency union—a formal currency union that involves sharing not just the currency but the infrastructure and particularly the central bank. Behind the central bank is the taxpayer, which in this case means the taxpayer in the rest of the United Kingdom.

The Chancellor of the Exchequer's response that he does not believe that a currency union

would be in the UK's interests accords with our research, which we have been publishing since last September. It suggests that a formal currency union between an independent country and the rest of the UK would be difficult to establish and would be in neither party's interests. That is a different view from what is often heard, which is that such a union would be in the interests of an independent Scotland but not of the rest of the UK. We do not think that such a union would be in either party's interests, because it would impose considerable restrictions.

Will currency union really be in the interests of the rest of the UK, as the First Minister stated? The benefit would be that there would be no costs for exchanging currencies for cross-border trade. That is absolutely true. The downside is that the rest of the UK would essentially be providing a form of insurance for a country that had declared that it wanted to be independent, which would open all sorts of moral hazard issues. It would also mean that because Scotland was a sovereign country, it could withdraw from the union at any time. We think that the restrictions that would be needed to make a currency union work would be too onerous.

The Convener: To return to my question, the decision by George Osborne and his colleagues is a rational one.

Dr Angus Armstrong: Based on our analysis, we think that it is entirely rational.

The Convener: Thank you. I am sure that other members will want to follow up on that question, but I want to move on and ask Mr Johnson a question; perhaps Jo Armstrong will respond to it, too.

Mr Johnson, I read with great interest the analysis that you published yesterday of the financial position that an independent Scotland could be in in the event of a yes vote. Would it be fair to conclude that people who think that voting yes to independence would lead to an escape from austerity are mistaken?

Paul Johnson (Institute for Fiscal Studies): The UK as a whole remains with very high levels of borrowing. The current UK Government's plans are to reduce that towards zero by 2018. The Scottish fiscal situation if Scotland were independent would not be terribly different from that of the UK as a whole. There is no getting round the fact that at some point and over some period some additional fiscal consolidation will be required. The current UK Government wants to get the budget balanced by 2018. The Opposition Labour Party suggests that it wants something slightly different that it calls current budget balance, which would require something like £25 billion less of spending cuts or tax increases. Within the UK debate, there is clearly some debate about how fast austerity needs to be introduced over the next several years.

However, were Scotland to become independent in 2016, there would remain a significant deficit, which would need to be addressed at some point. There is no getting away from that. Probably the biggest uncertainty is about the amount of debt that an independent Scotland would take on. If it were to take on a debt from 2016 that was shared on a per capita basis, for example, which would be about 70 per cent of its national income, that would be a considerable constraint and would certainly require continued movement towards budget balance over a relatively short period. If an independent Scotland were to take on a significantly smaller amount of debt than that, it would have more fiscal room for manoeuvre.

I therefore think that there is a big uncertainty about the level of debt that an independent Scotland would take on. The level of annual deficit that it would take on is less uncertain and would require dealing with at some point.

The Convener: Do you have a view on the question of debt? If an independent Scotland could walk away from a share of debt, however that might happen in practice, would that be positive or negative? We have heard some suggestion that it could be very negative in terms of the international markets.

Paul Johnson: That would depend on how it happened. In one sense, it would clearly be very positive. For an independent country to start off with no debt is rather a good place to be, compared with starting off with debt at around 70 per cent of national income, particularly for a country the size of Scotland and one that is new to the international markets. There would be significant benefits to walking away with no debt. I suspect that how that came about would be what would determine whether there were any additional, negative consequences in terms of credibility.

The Convener: Does Jo Armstrong want to come in on this?

Professor Jo Armstrong (Centre for Public Policy for Regions): Yes. Good morning. I agree with what Paul Johnson said. Having no debt to start with will always be a better position than taking on a significant amount of debt. There is the potential from how that is negotiated for Scotland not only to be seen to have been sensible but to have negotiated a very good deal. That would then free up the opportunity to raise more debt or borrowings for potential investment in infrastructure.

As I said in my written submission, the reality facing Scotland, whatever happens in September, is that Scotland and the UK have a big challenge on their hands. We must improve our productivity markedly from where we are at the moment if we want to have sustainable economic growth and high and rising real earnings.

Looking at the Scottish Government data, in 10 years of plenty we have reduced the gap between ourselves at the top of the third quartile of the Organisation for Economic Co-operation and Development countries and the bottom of the first quartile by 10 percentage points. That is in times of plenty. To improve on that and get into the top quartile would require us to do something quite remarkable. At the moment, we do not have from either side any narrative around how that will be delivered.

Having no debt at the start would certainly be a good position to be in. In that position, it would not be necessary to go to the markets as quickly in order to be able to borrow, and it would be possible to take time to build up a track record and to get a credit rating that allowed for a decent interest rate.

Dr Angus Armstrong: I strongly disagree with the notion of not accepting what most people would consider to be a reasonable and fair share of debt. Clearly, that number would have to be negotiated and decided—I do not know what the number is—but there has been discussion around a population share seeming reasonable. The First Minister has discussed that on television.

There are a couple of interesting things to note regarding the idea of walking away from that debt. First, the precedent that that would set for the rest of Europe would be extraordinary—any part could unilaterally have a referendum on independence and have no debt. There are a lot of places in Europe that would like to do that. People have to think about the broader consequence of that.

The second point is about borrowing costs. If I, as an international investor, am going to lend you money for 10 years, I want to know that there is a good chance of being repaid. This is not a great precedent.

The final issue is how the situation would play out in practice. Such a move would start a very difficult set of negotiations, which would require good will on both sides. That is why a reasonable number has to be negotiated. The oil contracts have to be transferred. The tax revenues are collected in London and passed to Scotland. People want all things to go smoothly. It is important that a very reasonable agreement is struck. Walking away from or reneging on it would be irresponsible.

Marco Biagi (Edinburgh Central) (SNP): Mr Johnson, you referred to the level of debt to gross domestic product that an independent Scotland would inherit if we got a population share of the UK debt. Is that a higher or lower debt to GDP ratio than that for the UK as a whole?

Paul Johnson: If you are including North Sea oil in the GDP, it would be a lower proportion.

Professor Jo Armstrong: If you excluded profits, dividends and interest extracted from the UK, it would be higher.

Chic Brodie (South Scotland) (SNP): I want to consider relative performances. According to any meaningful measure of the liabilities of the UK as a whole-be it trade deficit, fiscal deficit or debt per head as a percentage of GDP, it has been indicated that Scotland’s performance has outstripped that of the rest of the UK.

I want to ask Mr Johnson about his report. The Standard & Poor’s report described Scotland as benefiting

> “from ... investment-grade sovereign credit characterized by its wealthy economy (roughly the size of New Zealand’s), high-quality human capital, flexible product and labor markets, and transparent institutions.”

On the basis of all that, how would you describe the strength of Scotland’s economy? What do you think would happen to it if Scotland remained within the UK?

Paul Johnson: I do not disagree with any of that. Scotland is clearly a rich economy. Within the UK, it is one of the richest regions. No doubt it will continue to be successful, inside or outside the UK. I am not in a position to be able to say in any sense whether it would do better economically inside or outside the UK, but—

Chic Brodie: But the portents are there in terms of performance, particularly over the past 30 years.

Paul Johnson: The statement that this is a rich and successful economy is one that I entirely agree with.

Chic Brodie: Professor Armstrong, what credibility do you give to the projections from the Office for Budget Responsibility and their seemingly unending fluctuations?

Professor Jo Armstrong: For anything in particular?

Chic Brodie: No—just in general.

09:30

Professor Jo Armstrong: Okay—that is a wide-ranging conversation. I cannot give you chapter and verse on the OBR’s forecasting record. You would probably want me to say

something about oil price forecasts, since that is the most contentious element of the OBR's performance. The oil price forecasts by the OBR are the only official set of oil price forecasts that we have to date. My understanding is that the OBR takes its evidence from the Department of Energy and Climate Change, and its track record shows that it is consistently optimistic, as is Oil & Gas UK on output.

Since the OBR started, we have seen oil price forecasts coming down quite markedly. I think that they started at about £11 billion and have come down to about £5 billion on a like-for-like basis, so they have fallen dramatically since the OBR came into being. The OBR uses the best evidence that is available, and I think that what that tells us is that to forecast oil prices, then output from the North Sea and then tax revenues accruing as a consequence is an extremely difficult business, even for those who are the experts in the industry.

Chic Brodie: I return to the IFS report on the basis of the difficulty that we appear to have with the OBR's predictions. The projections do not account for the policy decisions that an independent Scotland might take; instead, the 50-year forecasts that we have seen are based on unchanged policy. Does Mr Johnson accept that an independent Scotland would make policy decisions that would build on the strength of the economy and that that would change the picture that has been presented?

Paul Johnson: With the long-term forecasts, we tried to replicate for Scotland what the OBR does for the UK as a whole. I do not think that anyone believes that the IFS report paints a picture of what the world will actually look like in 50 years' time. However, it sets out the constraints that are likely to face the UK and Scotland. In fact, the picture for the UK as a whole and that for an independent Scotland are not terribly different.

The constraints are driven by two things, one of which is demographic change. All western developed economies will see significantly ageing populations over the next 50 years, which will put additional strain on the public finances. In fact, we are seeing that over this decade. Across the UK, there has been a remarkable increase in the number of older people. There has been an increase of 2 million—20 per cent—just in this decade in the number of people over the age of 65. That has been known about for a while, but it is hitting the public finances as we speak. Spending on pensions is rising quite fast and the pressure on the health service and on social care is increasing as a result of that.

If we look forward, we can see that that trend will continue. The question is how to deal with it. No one is suggesting that it will be ignored, because it is clear that something needs to be done. That is one part of what the constraints are doing.

It is also important to look at the tax base and how it will develop. Across the UK, there are some important concerns in that regard. For example, corporation tax might continue on a downward trend over the long term because of difficulties from multinational companies about raising it. However, that trend has happened a lot less quickly than people thought that it would 20 years ago. On tax on petrol, it seems to be extremely difficult for Governments to even keep it up in line with other prices, so one might be concerned about that. However, if we are to meet or come anywhere near to meeting our climate change targets, there will be no petrol cars in 30 years' time, so there will be no tax on petrol. That is a very large amount of money to lose in the UK. More specifically in the Scottish context, there is also of course uncertainty about revenues from oil.

So, the second point is that there are concerns about the tax base. As you said, we know that now and we must therefore plan for the future. Again, whether it is an independent Scotland or the UK as a whole, those are significant challenges to face, which we hope—and to some extent believe—will be addressed.

Chic Brodie: Given the strength of Standard & Poor's report and the acceptance that the forecasts would obviously be affected by Scotland making its own independent decisions, I would like to ask a final question. If I read the Sheffield political economy research institute report, the NIESR report and comments by *The Wall Street Journal* on the strength of Scotland vis-à-vis the rest of the UK, I see that the studies are based on UK statistics and trends that relate to Scotland within the UK. Do you see anything within the UK that suggests that those trends would change if Scotland does not take issues into its own hands? Scotland would suffer decline if it stayed within the UK, would it not?

Paul Johnson: Suffer decline?

Chic Brodie: In relative terms, in light of the way that the rest of the UK economy is going. If Scotland were within the UK, we would obviously not have the opportunity to capitalise on our performance in recent years.

Paul Johnson: I really would not like to speculate on how the Scottish economy might develop whether it is inside or outside the UK.

Margaret McDougall (West Scotland) (Lab): Good morning, panel. I would like to discuss currency a little more. We heard the Chancellor of the Exchequer's statement, but we have yet to hear an announcement from the yes campaign on its preferred plan B. What would be the best currency option for an independent Scotland?

Professor Jo Armstrong: The currency expert—Angus Armstrong—is sitting on my right-hand side.

That is a very difficult question. All the various options have pros and cons. Again, it is about how the uncertainties that would arise from each of the alternatives would be managed, and it depends on the nature of the negotiation and the willingness of business to take the risks that would arise from being outside the sterling area. If I wanted to be truly independent and wanted full access to all the levers of power, I would want to try to make my own currency work, but there are lots of risks associated with that. However, that would allow absolutely full control of the fiscal levers, which an independent country would want.

Dr Angus Armstrong: I think that Scotland gains tremendously from being in a formal monetary union and that that is why the Scottish Government is so in favour of continuing a formal monetary union with independence. As that has been ruled out, the issue is then what is in the best interests of an independent Scotland. Based on the desire that is expressed in the white paper to build a Scotland that reflects the values and aspirations of the Scottish people, you would want something that provided the policy levers that enabled you to do that. In my view, there is only one option that allows that full range, and that is your own currency.

The Convener: Do you have a view on that, Mr Johnson?

Paul Johnson: I do not.

Margaret McDougall: What would be the effects of transaction costs on Scotland's businesses if there was a separate and different currency?

Dr Angus Armstrong: Obviously, there are currently no transaction costs for doing business. If Scotland had its own currency, there would be a transaction cost, so that would be a loss for Scottish businesses. The interesting question is: how much of a loss? That is a very contested area in economics. The debate is quite polarised, so I will simply report some of the findings that people have made.

Things are tricky, as a scenario always has to be run that involves the question: what if you had your own currency? The "what if" is key. One broad way to do it is to examine how those countries in Europe that did not join the eurozone but are members of the European Union or the European Economic Area fared compared with those that tied their currency even before the crisis. It is not a crisis issue. Between 2000 and 2010, how did the countries in the eurozone perform compared with those outside the eurozone, such as Switzerland, Norway and Sweden? It is hard to show that the export performance of the countries outside the eurozone was worse.

However, even that is not quite the right question. We are asking what it would be like to break a link rather than go to a link. The other scenario is going to a link, but breaking a link is the real issue. We have one nice example, which is Ireland in 1979. Its currency, of course, was linked to sterling and then Ireland joined the exchange rate mechanism, so the link was broken. Looking at the trend of Irish exports to the United Kingdom—there is a published and refereed journal article on that—it is very hard to discern a break in the trend. That is not to say that there is no effect, but it looks like the effect might be fairly small, based on much of the evidence.

Against that, there is one person—whose name will come to me—who has written extensively on currency arrangements and takes issue with all of those studies. Unfortunately, there are differences of view but, for me, the best way is just to look at how countries inside and outside a fixed currency have performed, rather than getting too bogged down in the methodology. It does not look like there has been a great deal of difference.

If Scotland had its own currency, that would not mean that it would fluctuate all the time. It would be important for Scotland to have a close peg to sterling. It is not as though the currency would, or would necessarily have to, fluctuate wildly.

Margaret McDougall: However, we have heard a statement from the yes campaign that there would be £500 million of transaction costs for the rest of the UK if an independent Scotland moved away from sterling. Are you saying that that would not be reversed and that there would be no costs for Scotland?

Dr Angus Armstrong: No. There would be costs. The question is how big they would be. Because Scotland exports a much bigger share to the rest of the UK than the rest of UK exports to Scotland, the costs would be much more on Scotland's side.

I do not know where the £500 million figure comes from. I have not seen the methodology that the yes campaign used to calculate it.

Margaret McDougall: Professor Armstrong, did you want to come in on that?

Professor Jo Armstrong: Yes. It is a slight aside, but we do not hear anything about the fact that parts of the country already trade in international currencies, so there would be no net additional transaction costs for them. For example, oil and gas are traded in dollars and the drinks industry probably trades in international currencies, too. Therefore, there would not be

additional costs to all parts of the Scottish economy.

Angus Armstrong says that Scotland would not have to worry about fluctuations. There is the possibility of some benefit from a country having its own currency, as that would allow it to depreciate and be more competitive.

Alison Johnstone (Lothian) (Green): I will direct my first question to Professor Armstrong and Dr Armstrong. My colleague Margaret McDougall was trying to ascertain the best currency option for an independent Scotland. Were Scotland to become independent, what would be the best currency option for the rest of the UK?

Professor Jo Armstrong: I will definitely cede to the currency expert on that one.

Dr Angus Armstrong: What currency option for Scotland would be best for the rest of the UK? The rest of the UK would keep its currency.

Alison Johnstone: If Scotland becomes independent, what currency option could that independent Scotland take that would best fit with the interests of the rest of the UK?

Dr Angus Armstrong: It would be in the best interests of the UK for there to be a strong Scottish economy—one that was stable and had no chance of imposing costs on itself. The best option that satisfies those criteria would be for Scotland to have its own currency and for it to be pegged against sterling.

On Jo Armstrong's point, I totally agree that having flexibility in place for when something unforeseen happens is a plus. You want to minimise noise and volatility, but you also want to have some flexibility.

Alison Johnstone: Thank you.

I move on to the subject of taxation and the possibilities that autonomy would bring to an independent Scotland. The IFS has noted in a report that, under devolved powers, the Scottish Parliament

"has eschewed more fundamental reform of these taxes."

I ask Mr Johnson and Professor Armstrong why they think that that is the case and what opportunities independence would give Scotland to improve on the current UK taxation system.

09:45

Paul Johnson: We start from a fairly sub-optimal tax system in the UK and in Scotland that could be made more efficient in a number of ways. One or two changes have been made in Scotland that have improved elements of the tax system. For example, the proposed change to stamp duty—I am not sure whether it is still proposed or has been implemented—is an improvement on the rather curious slab structure that we have across the rest of the UK. Stamp duty can go up by thousands when someone pays an extra £1 for a house. There are clearly some changes needed there. There is also a need to reform council tax. Such reform has not happened in Scotland, although I understand that it could have done.

I think that there are two fundamental questions. The first is about what a reformed tax system might look like and how an optimal tax system might differ from the tax system in the UK. In answering that first question, we could talk about an awful lot of things that might change.

Reforms to the VAT base and to the taxation of housing are long overdue. You could improve the efficiency of the direct tax system by bringing income tax and national insurance together. You could certainly improve the way in which the savings tax system works. There is a series of things that you could do, and I am happy to talk about any of them individually.

Those things have not changed because change often involves winners and losers. As you will know better than I, politicians find it difficult to implement change, even if the long-run impacts are positive for the economy and are, overall, more equitable. If even a small number of people are worse off as a result of change, that makes change difficult to achieve. I do not know whether that will be easier in an independent Scotland. I guess that, at the point of change, one has lots of opportunities, which one does not have in the usual run of things.

The second question is whether independence would change what the optimal tax system looks like, and I think that there are a couple of areas where it might. An independent Scotland would be a small country in competition with a larger neighbour right next door. In theory, the optimal rates of a number of taxes would be lower if the UK split and each side of the border started to compete with the other. In a sense, tax competition could drive the optimal tax rates lower on each side of the border. I know that there has been debate in Scotland about the potential for reducing corporation tax in order to take advantage of that kind of tax competition. You might expect something of that kind to occur.

I have mentioned taxation of petrol. On average, Scottish roads are significantly less congested than roads in England. I know that that is not true everywhere, but the result is that the optimal rate of tax on petrol is probably lower in Scotland than in England. There could be some changes of that kind.

We have talked about the costs of different currencies. Having VAT based in Scotland and VAT based in England is another thing that could increase the costs of doing business between the two countries. The more that tax rates and structures diverge, the more difficult it could become to do business between the two countries. The appropriate structures of taxation in Scotland and in the rest of the UK will be dependent on each other, to an extent.

Alison Johnstone: Professor Armstrong, do you think that Scotland has not been as bold as it could have been with the powers that it already has because it does not have all the powers and can continue to let others take decisions on its behalf? Will we see real, radical change?

Professor Jo Armstrong: That is not a leading question at all.

Scotland has limited tax powers. Clearly, what it has been able to do has been limited by the powers that it has. The white paper suggests that there are aspirations to reduce corporation tax and air passenger duty. A reduction in both of those is clearly targeted at creating a more attractive environment for inward investment and improving international connections to increase Scotland's export potential.

If we are talking about reducing taxes to increase competitiveness, the challenge that Scotland faces relates to the fact that, for any tax changes that it makes, it needs to find ways of filling the gap. Certainly in the short term—I do not know quite how long that short-term period would be—Scotland needs to find some other ways of filling that gap to fund current and anticipated spending plans. It is not clear to me exactly how that will be done.

There are opportunities out there but if they are to be live on day 1, we either increase taxes somewhere else or cut spending, given that we have a fiscal deficit and, potentially, limits on how much additional borrowing we can make.

The ideal time to make radical changes to your tax system is when you have money. That allows you to do difficult things and bring them in on a transitional or phased basis. We do not have that flexibility at the moment.

It is interesting to look at the taxes that have been deployed in Scotland. Council tax has been frozen, non-domestic rates for larger businesses have risen and small businesses have had tax breaks or holidays. It is difficult to understand the rhetoric around non-domestic rates. Rates are a business tax and the reality is that they have risen rather than fallen. However, the corporation tax aspirations appear to suggest that rates should fall. A lot of work needs to be done to understand what the appropriate mix should be, what it could be in theory and what is possible, given the financial constraints that we have and will continue to have for some foreseeable time.

Alison Johnstone: Thank you.

Joan McAlpine (South Scotland) (SNP): I have a supplementary to Alison Johnstone's first question, which was about what the best currency option for the rest of the UK would be if Scotland becomes independent. After some thought, Dr Armstrong, you said that an independent currency pegged to sterling would be the best option.

The Economic Affairs Committee at the House of Lords looked at the issue last year and said in its March 2013 report that an independent currency

"pegged to sterling"

would mean that a

"Scottish central bank would need to closely follow the Bank of England's policy, thus ... undermining the reason for introducing the new currency in the first place."

Would you care to reflect on that statement?

Dr Angus Armstrong: Sure. I should probably declare an interest—I was a special adviser for that House of Lords report. Of course that whole report was not my view—I have not been elevated yet. [*Laughter*.]

My view on that statement is that Scotland would peg an independent currency to sterling because it would like to have the exchange rate stability. It would mean that Scotland would give up a degree of monetary independence but when a rainy day happens—when a shock happens—Scotland would have a degree of flexibility. In the 1970s, the rainy day was the energy crisis; in the 1980s, we had very high unemployment; and, in the noughties, we had the financial crisis. It is not necessarily the case that Scotland would want to be adjusting things all the time or setting its own domestic interest rates. However, occasionally, when something really bad happened, it would need a safety valve to be able to make adjustments. That is why that statement was made.

Joan McAlpine: But even your best-case scenario for the UK imposes certain limitations on Scotland.

Dr Angus Armstrong: My best-case scenario?

Joan McAlpine: An independent currency that is pegged to sterling.

Dr Angus Armstrong: Some limitations would be imposed in that scenario, but I would argue that those limitations are the optimal choice of a trade-off. There is a trade-off between things such as exchange rate stability and the degree of independence in monetary policy that you have.

It probably makes no sense either to allow a lot of volatility in the exchange rate but have total independence or to have no independence and no flexibility—those are the two extremes. However, I accept that, for a very small, urban economy—that is not supposed to be pejorative; it is a genuine reflection of the importance of trade to Scotland—having stability in the exchange rate is probably closer to what is required than anything else.

Joan McAlpine: I have one more question, if the convener does not mind. How much control does Scotland have over monetary policy at the moment?

Dr Angus Armstrong: You know the answer to that. Monetary policy is not decided on a regional basis. There is a monetary policy committee that is made up of experts, and there is no regional representation on that committee.

Professor Jo Armstrong: There are, however, regional agents around the country, and they are asked about what is happening in the regions by the Bank of England on a monthly basis.

The Convener: Chic Brodie has a question. Please be brief.

Chic Brodie: I will be very brief, convener.

My question follows on from Alison Johnstone's questioning. The Standard & Poor's report states that

"The Scottish economy is rich and relatively diversified".

It goes on to say that

"Scottish wealth levels are comparable to"

those of several other countries, including Germany, and that

"Scotland would qualify for our highest economic assessment."

Let us look at the issue through the frame of reference of the rest of the UK—we always get drawn into looking at it through the Scottish frame of reference. Dr Armstrong made the point to Alison Johnstone that the rest of the UK needs a strong Scottish economy, which is verified by the Standard & Poor's report. Does that not mean that the Chancellor of the Exchequer's comment that he would not allow Scotland to share sterling is a piece of nonsense? Is it not sabre rattling and scaremongering?

Dr Angus Armstrong: I think that I answered that in my opening address. Because of the way in which the idea of a formal currency union has been laid out, the rest of the UK would be providing a degree of insurance for a country that could be bailed out, which means that it would want to put some restrictions on that currency union. In addition, the country that the rest of the UK was forming a monetary union with would have become a sovereign state and would be able to pull out at any time, meaning that the rest of the UK would want to place even more restrictions on the currency union because, I presume, the country would want to pull out at a difficult time for it. Therefore, I do not think that the chancellor's comment is nonsense; I am afraid that it is the reality.

I have not read the S & P report too many times and I do not have it in front of me, but I think that it includes the caveat that what is decided on the currency option is going to be a big deal. As we have tried to stress in all our research, the currency option depends heavily on what is agreed on the debt front. If Scotland has no debt, it is a totally different story. However, assuming that a fair share of debt is agreed it becomes difficult. I am talking about full monetary union.

The Convener: Our next panel of witnesses will be members of the fiscal commission working group, and we can ask them about that.

I will allow a brief supplementary question from Margaret McDougall.

Margaret McDougall: I want to ask Paul Johnson a question on taxation. If there was a separate taxation system in an independent Scotland, would there be additional costs for small businesses that were working with external businesses? Are there additional costs and bureaucracy implications that would be difficult for small businesses to deal with?

Paul Johnson: One should not overstate the scale, but there is no getting away from the fact that doing business across borders—particularly when the countries have different VAT systems—imposes additional costs and complexity. Plenty of business already takes place across borders and the system works perfectly well. Most businesses would be able to cope with it. However, creating borders and different tax systems would increase costs.

Professor Jo Armstrong: Different tax powers are being introduced under the Scotland Act 2012, so companies that operate across the border will already have to deal with different income tax rates.

Dr Angus Armstrong: I personally think that both Governments could be a lot bolder in their tax reforms. I take Paul Johnson's point, but the trouble is that there are winners and losers, which makes it difficult. Whatever the outcome of the referendum, it will be important for Scotland to have more tax powers, and that can be achieved in a way that people on both sides of the border find satisfactory. The difficulty is in taxing resources that are highly mobile, although that could be beneficial for both sides. That goes back to the point that I made to Ms Johnstone about its

being in the interests of the UK to have a strong Scotland, and Scotland's having more tax powers would be part of that.

10:00

The Convener: I have one supplementary question on tax, and then we will need to move on.

Mr Johnson talked about the ambition of having a simpler tax system. We know that the UK tax code is complex. It has been built up over a long period and lots of vested interests have secured concessions. Given that, why does the white paper say that an independent Scotland would automatically adopt the entire UK tax code? Surely that would be a great missed opportunity.

Paul Johnson: A tax code would be needed on day 1, and to write one from scratch would be a heck of a business.

The Convener: Would it not be a lot simpler to make changes before the system was brought in rather than just adopt what we currently have and then try to make changes?

Paul Johnson: Some changes could be made, but it would be pretty difficult to make wholesale changes or to start completely from scratch. You might want to bring it in and say that you will have a big reform a few years down the road but, for the transition, you will want to start with something relatively familiar. I presume that, over time, the systems would diverge.

The real question is whether the political and other pressures on an independent Scotland in developing its tax system would be noticeably different from those that apply to the Westminster Government and which have, as you described, resulted in a complex system. There are two parts to that, one of which is a straightforward political issue. Yesterday, I was talking a bit about business rates, which have been a pretty stable tax in the UK as a whole but which over the past three years have been complicated by a series of measures. That has happened in Scotland a bit, too.

The second issue is to do with international mobility and difficulties to do with avoidance. A lot of the complexity is built up in trying to deal with that, and it is hard to see why it would be easier for Scotland to deal with it; indeed, it might be more difficult.

The pressures might not be dissimilar, although the opportunity presented by the big change might allow significant change to things such as the structure of income tax, national insurance and the VAT system.

Christian Allard (North East Scotland) (SNP): I have a question for Paul Johnson on the Office for Budget Responsibility figures, which are used in the IFS analysis. There is some disparity, because the OBR figures do not correspond with what experts and the industry say. For example, Professor Kemp has said that the OBR has predicted 6 billion barrels fewer than he expects. On my last visit to BP, I found that it predicts an increase in production from 2013 to 2017 and going forward from that. The figure was from Oil & Gas UK. Even the Scottish Government totals for recoverable oil and gas are less than those that BP uses. The Scottish Government is talking about 24 billion barrels, whereas BP is talking about 27 billion. Who is right and who is wrong? Whom should we trust?

Paul Johnson: I do not know who is right. As Jo Armstrong said, looking back the OBR and Department of Energy and Climate Change figures have generally been overoptimistic, although they might turn out to be pessimistic looking forward. I do not know what is right, but the uncertainty is the key issue. Oil revenues might or might not turn out to be significantly higher than the OBR suggests. However, it would be incautious to assume that revenues will be at the optimistic end of forecasts and to plan budgets, spending and fiscal policy based on that optimistic assumption.

The question, which the fiscal commission is thinking about, is how to account for oil revenues in setting budgets and fiscal policy. You have to think about them differently from how you think about other revenues, because you can see how volatile they have been historically. The issue is less about who is right and who is wrong and more about how to deal with the significant uncertainty and volatility that are inevitable for what will be a large chunk of the revenues in an independent Scotland. Simply to assume that the optimistic levels are right and that you can pay for day-to-day spending all the way through with that revenue will not be an adequately prudent approach.

Christian Allard: BP is investing based on those figures. That is its forecast and it is working with those numbers, and so are all the companies in the North Sea.

Paul Johnson: That is as may be, but my point is not that I think they are wrong or right, but that to plan the budget one must take account of the fact that the numbers are uncertain. If they are uncertain, you need to think about those revenues differently from how you think about income tax or VAT revenues, because of the volatility that is inherent in them, and because in the long run they may disappear.

Professor Jo Armstrong: I wanted to pick up on the point about the experts' projections. You are absolutely right to say that there are lots of projections out there. Twelve months ago, Oil &

Gas UK was talking about a more bullish outcome than it is talking about now, so it has pegged back its projections. The OBR's projections include output based on the current record levels of investment, so it is not as if it is ignoring that output.

It is also important to reflect on the fact that the Scottish Government itself, a little more than 12 months ago, prior to knowing that the 2012-13 output did not bounce back, had oil price projections by the end of the forecast period ranging between £4.1 billion and £11.8 billion per year. The Scottish Government itself acknowledges that the range could be extremely wide.

Christian Allard: There is still a vast difference between the OBR and the—

Professor Jo Armstrong: No. The OBR's figures are within that range; the Scottish Government's own scenarios are extremely wide. It is a question of how that information is used to plan spending. It is not a case of saying, "If it comes in, we don't want it." It is about planning current day-to-day spending on the basis of that income, which is about 15 per cent of Scotland's tax take, as opposed to 2 per cent of the UK's tax take. It is not something that is not wanted. It is wanted, but you need to know how to use it to plan your spending. The range of volatility that the Scottish Government accepts is extremely wide.

Dr Angus Armstrong: The point on volatility is important. We suggested six months ago that a bigger country with deeper pockets and a currency of its own that it can print is probably better able to handle volatility. If it can be agreed what the expected amount of oil is, an optimal action—for once, it can be shown economically that there is such a thing as a free lunch—is to do a swap between the oil and the debt, which would leave an independent Scotland with a much lower level of debt and give a whole different meaning to the debate. That is assuming that a debt-for-oil swap could be done; I understand that that would be politically extremely different, but as an economist I believe that the option should be on the table. It would be a genuine free lunch.

Christian Allard: Do you disagree with the BP forecast?

Dr Angus Armstrong: I do not have any view on BP's forecast. I am simply pointing out that businesses can at times be overly optimistic and overly pessimistic. That is all.

Christian Allard: I have one more question for Professor Armstrong. Your report from October last year stated that setting up both a stabilising fund and a savings fund, as the fiscal commission working group has advocated, would be desirable. Why?

Professor Jo Armstrong: As an economist looking at a commodity that will be depleted and not renewed, one would hope that generations to come will benefit from that asset. If moneys were to be set aside in a stabilisation fund or an oil fund, that would give the opportunity for them to benefit. The challenge at the moment is how to do that when there is a fiscal deficit.

Christian Allard: Do you think that the UK Government should have followed the Norwegian model?

Professor Jo Armstrong: I think that now the UK Government would accept that it would have been nice to have such a fund, but the money was used for other things, and Scotland benefited from those other things.

Christian Allard: It is still possible to follow the Norwegian model for whatever happens in—

Professor Jo Armstrong: The Norwegian model is a different model. It did not simply take tax returns and put them into a fund. The Norwegian model was about the Norwegian Government investing in the North Sea. The UK Government at the time chose not to do that; it did not have the coffers to do that at the time, so it used international capital to invest in the North Sea.

Because the Norwegian Government was smaller and was dealing with gas rather than oil, it did not have the same desire or ability to invest at the same speed as the UK. The Norwegian Government chose to retain some ownership of the assets and it is the ownership dividends that are increasing the Norwegian funds, not the tax take.

Christian Allard: That is an interesting point. In his report, Sir Ian Wood—

The Convener: Mr Allard, you have had six questions and we need to move on. I am conscious of time and a couple of members have supplementaries.

Marco Biagi: The OBR gets a lot of currency—pardon the pun—from being independent of the UK Government, but two of the panel have referred to its use of Department of Energy and Climate Change analysis as an information source. Is there a conflict there?

Paul Johnson: The OBR is an organisation consisting of about 20 people, so inevitably it uses evidence and data from other experts. Its role is to test that information. For example, if the OBR was going to look at how much tax might be raised from a tax-rate change, HM Revenue and Customs would do the initial work, which the OBR would then challenge and refine. It would chuck it out if it was wrong or use it if it thought that that would be appropriate.

The OBR is independent in that sense. It is not independent in the sense that it has 500 people who repeat from scratch all the work that is done elsewhere across the economy.

Professor Jo Armstrong: You could argue that the Council of Economic Advisers has a similar challenge on its hands.

Joan McAlpine: Witnesses have all talked about oil's volatility and the fact that Scotland is dependent on oil for 15 per cent of its tax take. Norway is dependent on oil for 30 per cent of its tax take and has been exposed to the same volatility as every other oil-producing nation has, yet the UK's projected debt is £1.5 trillion and Norway is in surplus. How do you explain that?

Dr Angus Armstrong: The key difference is the combination of debt and Scotland's not having access to its own currency. In all these things it is not a question of what happens when everything goes well; you have to imagine how things would play out if things were to go badly, and what the scenarios would be.

If there were no debt, oil volatility on its own would not be a great issue. It would be problematic, but it could be managed. However, with a high level of debt, the ability to borrow when the oil price falls—if it genuinely is volatile—could be limited, which is where things start to get difficult because the options start to run out.

The difference is that, in effect, you would be using somebody else's currency. Assuming that there will be a deal on what would be a fair share of debt, which most people say is about 80 per cent of GDP, the situation will not be the same as it is in Norway.

Joan McAlpine: I did not ask about that. My question is perhaps more simple: why is Norway, which is a small country that is dependent on oil revenue for 30 per cent of its tax take, doing so much better than the UK?

Dr Angus Armstrong: I will try again. Norway is doing better because it has no debt.

Joan McAlpine: It has no debt because it has access to its own oil revenues.

Dr Angus Armstrong: An independent Scotland would start off with, I presume, a debt of about 80 per cent of GDP, based on a per capita slice of it. The starting point will be that fixed cost plus the volatility, and the fact that you will have locked the cupboard on one of the options: monetary policy. That is why the situation would be different.

Norway has its own currency; that is different. Norway does not have the same level of debt; that is different. Volatility? Without those two differences, yes, you could manage it.

Paul Johnson: Joan McAlpine is almost asking a backwards-looking question. I think that she is asking why Norway managed things better than the UK, which is a very big political and economic question. As Jo Armstrong said, the UK used the oil revenues in the 1980s when they were very high, rather than storing them away as Norway did.

You could ask Joan McAlpine's question about any economy. Some economies have done better than the UK economy and some have done worse. We have higher debt than a number of economies, which is partly to do with the fiscal regime before the recession and partly to do with the scale of the crisis as it hit the UK.

The Convener: We need to move on because we are going to run out of time.

Richard Baker: Perhaps a state-owned oil and gas industry would be the right way forward, but I will not dwell on that point. I want to continue with a question about oil and gas revenues. We can have the debate about debt but, whatever happens, Scotland will not be free of liabilities, and the costs of decommissioning have been estimated at between £20 billion and £47.5 billion. I understand that the Scottish Government has made a commitment to underwrite that to the tune of £20 billion. To what extent have you been able to factor that into projections that you have made of future revenue streams for an independent Scotland?

10:15

Professor Jo Armstrong: I do not have any model to project other than to take a straight-line extrapolation. The OBR is indicating that, at some point, decommissioning will start to have an effect. I will have to check, but I think that by the end of the current forecast period we will see some decommissioning costs coming in. That means that the tax take from some of the oil companies will be reduced because they will get reliefs for those decommissioning costs. As those start to ratchet up, it will have an effect on what tax accrues to the UK or the Scottish exchequer—whichever would be the appropriate body. That decommissioning effect is, I presume, why the OBR's long-term projections are for a long, slow, steady decline in North Sea taxes as a share of national income.

Richard Baker: That decline might already be being taken into account.

Professor Jo Armstrong: It is certainly in the OBR's long-term projections.

Richard Baker: The most recent UK oil and gas activity survey shows that what we have in the North Sea has a long future, but lower production

and rising costs to the industry mean that it is difficult to justify the tremendously optimistic projections about the tax revenue from the industry in the longer term.

Professor Jo Armstrong: It is important to differentiate between output and jobs and tax take. The Wood review report suggests that if there is to be a long term and very productive output from the North Sea, we have to consider a much more flexible oil-tax regime. That means one thing: less tax per barrel than is currently the case to maintain the life of the North Sea.

Richard Baker: You are saying that we can sustain jobs in the industry, but maintaining a high level of tax return is far more difficult.

Professor Jo Armstrong: Yes.

Paul Johnson: I am sorry to repeat this, but the absolutely crucial point is less about what the different views of the future are, and much more about the fact that there is just a lot of uncertainty and volatility. I urge the committee to listen to Angus Armstrong, because the view that he expressed earlier about the oil-for-debt swap is an extremely creative and potentially beneficial policy that would achieve precisely what he described. You would have a bigger economy that would be more able to cope with volatility by swapping volatility for some of the debt that a small economy would find it difficult to live with.

I understand that creative ideas like Dr Armstrong's have political aspects, but from the economic point of view, it would benefit everyone and is well worth being taken very seriously.

Richard Baker: That might, however, also involve agreement on responsibility for the decommissioning costs. It would become quite a complicated arrangement.

Paul Johnson: A very complex negotiation would be needed to get what both sides would feel was a fair deal at the end, but because of the costs to an independent Scotland of volatility and large amounts of debt, there would be room for both sides to be better off within quite a wide range of outcomes. That is exactly the kind of thing over which it would be right to negotiate.

Mike MacKenzie (Highlands and Islands) (SNP): My question is for Mr Johnson. Why have countries such as Austria, Sweden, Denmark, Switzerland, the Netherlands, and Norway got significantly greater levels of productivity than the UK?

Paul Johnson: If I knew the answer to that and had a way of translating it into UK policy, we would have done it, but I do not know the answer. There are all sorts of elements in the institutional and economic arrangements of those countries that result in higher productivity.

The story of UK productivity has not been a bad one, at least until 2007. From the late 1970s to the late 2000s productivity increased faster in the UK, from a relatively low base, than it did in most other OECD countries. The picture in that period was not totally gloomy, as it is often described; there were significant improvements in productivity.

There are clear problems, and there has been a short-run big issue with UK productivity since 2007. Productivity has taken a significant dive as a result of a combination of high levels of employment and low levels of wages and business investment. I expect and hope that that is a short-run phenomenon, and that things will start to get back on to something like the track on which they were before, but that remains to be seen. At a macro or high level, it is pretty clear that the elements that matter for productivity are a stable and efficient tax system, an effective education system, good levels of public investment in infrastructure, and a tax and financial regime that allows investment by the business sector and so on.

Mike MacKenzie: Is it fair to say that, unlike other countries, the UK has not been able to provide the type of regime that you describe?

Paul Johnson: We struggle in some areas. There are areas in which we do well and areas in which we do less well. Some elements of our tax regulatory regime are relatively competitive and effective, but in some areas of tax, and certainly in some areas of education, we are less effective. The UK has some of the least well-educated young people—indeed, people in general—with regard to literacy and numeracy in the whole of Europe and the OECD countries. At the top end, however, we are doing very much better. As with all such things, there are areas in which the UK is doing badly and areas in which it is doing better.

Mike MacKenzie: You will be aware that the Scottish Government is advocating the introduction of universal childcare. Current calculations suggest that, under the current regime, we would receive only about £45 million of the enhanced revenues of the £700 million that the policy would create. Do you see anything in other parties' proposals for enhanced devolution that would enable us to introduce such a game-changing policy?

Paul Johnson: There is a prior question to consider with regard to how effective universal childcare or increased public childcare provision is, or would be, in increasing revenues by producing an increase in the labour supply. All the main UK parties as well as the Scottish National Party are very much in favour of increased spending on childcare; that spend has risen substantially across the UK every year for the past

20 years, and the UK is now towards the top of OECD league tables in that regard.

However, I have some worries about how the money is spent. The evidence on the relationship between universal childcare provision and female labour supply is nothing like as strong as you might expect it to be, so I would not expect an additional X hundred million pounds of spending on childcare to pay for itself in any sense through producing additional tax revenue. I take issue with the consensus across all parties that more should be spent on childcare because it will have big effects on child development and on the labour supply, because I do not think there is any evidence to support either of those statements.

Dr Angus Armstrong: The evidence for early childhood interventions—in particular from the United States—is very positive but, as Paul Johnson said, we have invested a lot in childcare for the past 20 years. There will be a great deal more interesting work in that area, so I commend the Scottish Government's efforts in that regard.

On the question about productivity—which is the golden question, really—there is an interesting piece of work to be done about levels of productivity and the degree to which we should have devolved, or federal, taxes and whether that helps productivity. The nub of the issue is whether it is better to make local or central decisions. We would be happy to undertake that very interesting piece of work and to send the committee our results.

Paul Johnson: I will clarify my points on childcare. I agree entirely with Dr Armstrong about the positive effects of targeted childcare policies on disadvantaged populations. There is very good evidence that those expensive and well-targeted policies are effective, but that does not seem to be what any of the main parties are talking about with regard to their additional childcare spending.

Chic Brodie: I have a supplementary question.

The Convener: Be brief.

Chic Brodie: I will be brief. I follow on from Mike MacKenzie's question about productivity. The Sheffield political economy research institute report says that, because of the UK economy's weakness, potential benefits to that economy—particularly from oil revenues—have been squandered in favour of boosting financial services concentrated in London. To return to my earlier question, is there anything taking place in the UK to suggest that that trend would not continue? Would it therefore not be better for Scotland to control its own economy?

Paul Johnson: You can make a serious argument that the UK had a lot of oil revenues in the 1980s and a lot of revenues from the financial services in the 2000s, which it used for day-to-day spending. In a sense, the UK as a whole did not follow a terribly cautious policy in making use of those revenues by building up a fund or in recognising that they would be lost in the long run. In a sense, I have some sympathy with your look back at the failures of history, but I would not speculate on who would do a better job in future.

Chic Brodie: The question is very much about the future, which is why I asked about Scotland controlling its economy.

The Convener: Okay. We are short of time, so we need to move on. Marco Biagi has the next question.

Marco Biagi: This question is for those of you in the business of projections—Professor Armstrong gets a bye on this one.

The models that I have seen are based on an assumption that Scotland takes on a share of the debt and often incorporate higher borrowing costs. On the other hand, the fiscal commission suggested an approach—it appears to be the one that would have to be taken—whereby Scotland would finance a share of the UK debt. Does that have an impact on the projections, which clearly use the level of the UK's borrowing cost rather than any level that we might debate for an independent Scotland borrowing on the markets?

Paul Johnson: I will leave Dr Armstrong to answer the question about what the likely level of interest rates might be. We have looked at the sensitivity of our long-run projections to different interest rates, including an assumption that Scotland was able to borrow at the same rate as the rest of the UK, which is at the optimistic end of assumptions.

The big story does not change terribly in the long run. The big thing driving what will happen in the long run is demographic change, which affects the UK but may perhaps affect Scotland a little bit more, depending on what happens to migration and to the tax bases. Higher borrowing costs clearly create additional difficulty, but our long-run report looks at assumptions that include no higher borrowing costs.

Marco Biagi: That was in your so-called optimistic model.

Paul Johnson: Yes.

Dr Angus Armstrong: The report was not a forecast; rather, it was an estimate based on what happened in the European Union between 2000 and 2012, in which we tried to control for the impact of the crisis countries, so that we did not get pulled in one direction as a result of that impact.

I assume that, under the fiscal commission's proposal, as the debt matured, an independent Scotland would have to pay a share of the debt maturity. Quite a lot of the debt is payable in the next three years—that is the yield curve—so there would have to be a lot of issuance. The question is what price people would charge you for borrowing that money, knowing the debt that you would eventually take. We are arguing about timing and not the amount—we assume that the amount is agreed, whatever the negotiation is. Playing around with the timing is a timing issue, but the price is based on the probability of the debt being repaid, and that would be based on the level of debt that you would take on, not the timing of it.

Marco Biagi: But the relationship is between an independent Scottish Government and the UK Government, which has confirmed to the markets that it is ultimately responsible for all the debt.

10:30

Dr Angus Armstrong: Absolutely. The UK Government has done what in my view was a very obvious and boring thing to do, which is to reaffirm that Her Majesty's Government's debt will stay that Government's debt and that the Government will not default on it, as it has not done since Charles II. The question then is how we strike a deal. What would the cash-flow payments be and what is the net present value of that? It seems that population share will give the estimated number for the agreed amount, which will be one of the factors that will determine what people will require as a rate of return—the interest rate—for borrowing.

Our estimates were based on comparison with the European Union, which is of course a formal monetary union. If formal monetary union was ruled out for an independent Scotland, the interest rates would be higher.

Marco Biagi: I have a question on a slightly different topic for Mr Johnson. You have said today that there is uncertainty in all your projections, whether for Scotland or the UK. Is it fair to say that the revision that you have undertaken today and the observation that was published yesterday show the level of uncertainty that there is in any form of economic projection?

Paul Johnson: Yes. What we published yesterday was really an update based on new information that was published after the autumn statement by the OBR. There was some good news in that, because its growth projections were higher than they were in the previous budget, so for the UK as a whole and for Scotland things look a bit better than they did a year ago. There were also changes to the oil revenue forecast. These things change as forecasts change and, as we have seen from the OBR over the past three years, forecasts can change very dramatically indeed. If you cast your mind back to autumn 2010, the Government hoped then to have dealt with the fiscal problem by 2015. However, growth has turned out to be very much less than was projected then, with the result that the fiscal situation is very much worse than was hoped. Yes, there is no question but that the projections will be wrong, but they are the best things that we have to work with at the moment.

Marco Biagi: I have a final question for Dr Armstrong. You seem quite supportive of more efficient taxation through the devolution of powers. Do you believe that, all things being equal, having greater fiscal powers leads to better economic performance? Or is answering that question the purpose of the research that you were talking about?

Dr Angus Armstrong: With tax you cannot take an all things being equal scenario and ask whether, if you changed just this lever and pretended that nothing else changed, you would be better or worse off. You cannot answer that question, because other things change.

In my view, without having done the research, are there perfectly reasonable powers that could be used already? Greater powers could be transferred to Scotland, and to Wales, Northern Ireland and the rest of the UK. Could the whole constitutional arrangement be redrawn in a more coherent fashion? Although I have not done the research, my feeling is yes.

Marco Biagi: By "coherent fashion" do you mean in a way that would result in better economic performance?

Dr Angus Armstrong: Correct. There are also a lot of non-economic issues to be considered, which is perfectly reasonable, but from an economic perspective it is about productivity and standard of living.

The Convener: I have a follow-up question to Mr Biagi's first question on borrowing costs. What do you estimate borrowing costs would be in an independent Scotland if there was no monetary union?

Dr Angus Armstrong: Unfortunately, that is very difficult to say, because we have to find a counterfactual. We have to find somewhere as the basis on which to estimate. The European Union—taking the crisis countries out of it—provided a nice test tube in which to do the experiment. If we leave out a formal monetary union between the rest of the UK and Scotland, the question then is what we can compare an independent Scotland with. That is when it starts to get very messy. Unfortunately, I do not have an answer to your question. Borrowing costs are, however, more likely to be lower in a formal

monetary union than in an informal monetary union. I do not have an estimate.

Joan McAlpine: My question is for Professor Armstrong. You said in your submission that the Barnett formula's future arrangements "appear uncertain". You will obviously be aware of the Holtham commission, which found that implementing its proposals would result in a £4 billion cut to the Scottish budget. What challenges would Scotland face if there was a no vote in September and the Barnett formula was scrapped?

Professor Jo Armstrong: I do not think that the Barnett formula will be scrapped, but it will be adapted. I doubt whether anybody would seriously suggest that it will not be adapted. The formula has continued to be adapted over time and it is being adapted as a consequence of the Holtham commission and possibly the guys from the IFS assisting the Welsh Assembly Government to identify the fact that the treatment of non-domestic rates is not similar across Scotland, Northern Ireland and Wales. So there has been adaptation already.

The reason why I think that there will be further adaptation is that the Welsh Assembly Government and the Northern Ireland Assembly are beginning to understand the pros and cons of having their own taxes and are pushing harder on that. There is also the fact that Scotland has a challenge on its hands. Scotland has said that having a higher per capita share of the Barnett formula is justified by North Sea tax revenues, which are of significant benefit to the whole UK. However, as those revenues start to decline, it becomes harder to justify to those in the north-east or south-west of England that Scotland should get a higher per capita share of the formula if it cannot prove the same needs requirements. On a needs basis, the Holtham commission clearly signalled that it is difficult to justify Scotland requiring in totality the same level of support as other parts of the UK might currently require.

I think that the move would be for further changes in the Barnett formula, but I also argue that, on the basis that the formula was a political construction in the first instance, there would be political negotiation on what changes would be required and what transitional arrangements would be made. I think that the formula will be changed.

Joan McAlpine: Are you saying that the Barnett formula will not be scrapped, but that it could be adapted in line with Holtham?

Professor Jo Armstrong: I am not sure that Holtham will be used. I think that a host of analyses will be done and that a variety of bodies will be involved, not least the UK Treasury. Holtham is an opening shot and a negotiating position.

Joan McAlpine: Will the UK Treasury do most to determine what happens?

Professor Jo Armstrong: The UK Treasury holds the black box, so it will be in control.

Joan McAlpine: Will the UK Treasury decide Scotland's future after a no vote?

Professor Jo Armstrong: The UK Treasury will offer the Scottish Government the funding required. There will be a negotiated settlement that will involve politicians from all parties in all regions of the UK.

Joan McAlpine: Right. Thank you.

The Convener: We will call it a day at that, because we are already behind the clock. It has been a very interesting session and I am very grateful to the witnesses for coming along and helping the committee.

I suspend the meeting for three or four minutes to allow a changeover of witnesses.

10:37

Meeting suspended.

10:44

On resuming—

The Convener: Moving on to the second panel, I am delighted to say that we are joined by Crawford Beveridge, chair of the fiscal commission working group, and Professor Andrew Hughes Hallett, who is a member of the working group. Welcome to you both.

I invite Mr Beveridge to set out the commission's work.

10:45

Crawford Beveridge (Fiscal Commission Working Group): Thanks for having us here, convener. I will not say very much, as I suspect that people are mostly interested in what we have been doing about currency. We will get into all of that.

Members will have seen our submission to the committee. About 12 months ago, we published the potential macroeconomic framework for Scotland in the event of independence. In that report, we considered the currency options, which, as we expected, have become one of the big focuses for everybody.

As you know, at the time we made a strong proposal for a currency union, which, famously, has been called plan A in some areas. We really

believed that the move was in the best interests of both Scotland and the rest of the UK. Today we can make some observations about not only that report but some of the other interventions that have been made over the past six months or so.

The fiscal commission working group is meeting again tomorrow, and we have a Council of Economic Advisers meeting on Friday. We tend to try and line up those meetings when everybody is in town. I cannot tell you the latest thinking of that group of people, because we will not know that until this time tomorrow, but I am 90 per cent certain that what will come out of that meeting is a belief that the group will reaffirm its advice to the Government that a currency union is the right option for Scotland.

We will certainly consider the other options, but when we look at them, the evidence tends to push us all the way back to a currency union as the best option for everybody. I am certain that, in our future work planning, we will try to take a little more time to see what we can do to show some of the advantages of such a union for the rest of the UK—we can show that easily for Scotland—and the disadvantages of going in a different direction.

With that, convener, I will go wherever you all want to go.

The Convener: Thank you very much for that introduction. As we have about an hour for this session, I remind members to keep their questions short and to the point, so that we can get through the various subjects in the time available to us.

Mr Beveridge, you have already touched on some of the topics that will come up, but I will start by asking you about some of the evidence that we have just taken from the previous panel. I am not sure whether you managed to catch it, but Professor Angus Armstrong—I am sorry, I am elevating him; he is Dr Armstrong—whose work as a currency expert you will be familiar with, told us, if I noted it down correctly, that he did not think that it was in the interests of either Scotland or the rest of the UK to enter a formal monetary union, essentially because it would put too many restrictions on both parties and the element of risk sharing would be too high.

Last week, we saw an intervention in *The New York Times* from the Nobel prize-winning economist, Paul Krugman. I know that you have Nobel prize-winning economists on your advisory body, but Professor Krugman said that thinking on the monetary union by “the independence movement”—I suspect that he meant yourselves—has been “deeply muddle-headed.” He went on to say:

“sharing a common currency without having a shared federal government is very dangerous.”

Why is he wrong?

Crawford Beveridge: I will let Andrew Hughes Hallett answer, too, but what I will say is that we will stack our Nobel economists up against that Nobel economist any day of the week. As you will see if you read his columns regularly, Paul Krugman has very strong views. We would have responded had it not been for the amount of evidence to show that, when you take him on, he likes to carry on fights in public for a very long time.

The Convener: I think that we would enjoy watching that.

Crawford Beveridge: There is no question but that he and Dr Armstrong are correct about the constraints imposed by any kind of currency union. Whether or not we entered into that union, constraints would still be imposed; whether we like it or not, the market imposes constraints on people. If you have talked to the Financial Services Authority recently, you will know that it said that something like 80 per cent of its regulation now comes from Europe. It does not even come from the UK. We believe that the upside of a currency union far outweighs the downside.

However, I am a simple businessguy. Andrew is the real economist, and this is his work.

Professor Andrew Hughes Hallett (Fiscal Commission Working Group): The essential point is that no system is absolutely perfect in every respect that you might imagine; as a result, it is a question of balancing the pros and cons.

By the way, I apologise if my voice goes. It must have Alzheimer’s—it keeps disappearing and coming back.

I am a bit disappointed in Paul Krugman, because what he said does not show tremendous judgment. For example, he did not go into why there might be some restrictions. However, I did not read the *New York Times* article, so I am not sure of the specifics of his argument.

As for Angus Armstrong’s points about too many restrictions and too much risk sharing, I am not sure how there can be too much risk sharing. Is that part of the restrictions? I find that confused. I do not know what too much risk sharing means. I understand risk sharing, but too much—

The Convener: I think that Angus Armstrong said that the level of risk, particularly for the larger economy—in this case, the rest of the UK—was so substantial that it was not in the rest of the UK’s interests to enter into such an arrangement.

Professor Hughes Hallett: Surely the risk is the other way round. I think that, proportionately speaking, something that goes wrong in the rest of

the UK will have much more of an effect on Scotland than it will the other way round. If, for example, the rest of the UK had excessive fiscal deficits, that would have an effect on Scotland. Proportionately speaking, the same-sized fiscal deficit in Scotland would not have that huge effect on the rest of the UK. As I have said, the thinking is muddled.

Crawford Beveridge is absolutely right about restrictions. Whether or not a country is in a monetary union, there must be restrictions in the system. People talk about having fiscal restrictions in a monetary union, but the fact is that they prevent bankruptcy. I think and hope that you will recommend that, whatever system is chosen, there be some restraints on fiscal policy to prevent bankruptcy. I am not allowed to say this, but we do not want to go Greek. In this case, there are natural restrictions.

We should consider what happens if we have restrictions—and, indeed, we should bear it in mind that those restrictions are not on either spending or revenues but on the difference between the two. They adjust the aggregates. You can do whatever you like with all the bits and pieces inside, as long as you do not have excessive deficits. In addition, things do not have to be exactly in balance, although they have to be in reasonable balance.

I presume that some restrictions on debt would be wanted. Restrictions on debt would imply something about deficits, and deficits per se would not have to be worried about—one would just focus on the debt. That would make a lot more sense.

Such restrictions exist purely to prevent bankruptcy. After all, the markets will take revenge if a country goes bankrupt because it has not been sensible. However, that is nothing to do with the monetary union; it is a general possibility that will exist alongside the other options that you might consider.

That is on the fiscal side. As for the monetary side, it all depends on the monetary union that a country is in. If a country is in a multilateral monetary union—in this case, a bilateral union in which the currency is shared between two countries, or what is known as plan A—it will have a small effect on and jointly decide policy. In other words, that is a restriction, because one country in the union cannot do something crazy with regard to the other country.

Alternatively, there is also the one-sided union, which is not plan A. It provides a useful point of reference. In such an arrangement, a country will have no control over monetary policy, but will simply take what it is given from the other party. That is what used to happen in the European monetary system before the euro when the whole thing was, in effect, German run. That might be a small sacrifice.

If the country was outside the monetary union and completely free, it would not, for fairly obvious reasons, have complete freedom to set its monetary policy because it would still be in an interdependent world. Similarly, it could not do anything crazy, because if it did, there would be hyperinflation, hyperdeflation or some other natural restriction.

Therefore, I do not think that it can be argued that there are too many restrictions. One might want slightly fewer, but one would then have to balance up the costs from elsewhere.

The Convener: Do you accept that a successful monetary union needs, as Professor Krugman suggested, a high degree of fiscal integration?

Professor Hughes Hallett: You will probably have that anyway. You might not need it, but if you do not have it the monetary union will be slightly more difficult to run.

If we were in Brussels, you would have just asked the nuclear question. We are told that there must be a fiscal union, which is a kind of super form of fiscal co-operation, but the answer to the question is that there does not need to be such a union at all.

I am sorry to be pedantic, but we have to go back and look at the three financing imbalances in the economy as a whole. First, there is the savings and investment one, which is all to do with the regulation of banking; secondly, there is the fact that the Government is spending less revenue, which is all to do with the fiscal deficit; and, thirdly, there is the trade deficit including net factor income, which we can think of as exports minus imports. Those three things have to add up.

It is entirely possible to have an imbalance in the banking sector, with too little in savings or whatever, or an imbalance in the trade sector. That will force the fiscal deficit to be too large, and you will have a problem. However, no amount of fiscal union will get you to control the other two imbalances. That is why a fiscal union is not in itself necessary. It might help, as would a degree of co-ordination, but it is not actually necessary. You need to be clear on that.

The Convener: Thank you. I have one more question before I bring in Chic Brodie. What historical models did you look at in your work? Are there any examples of countries that have dissolved a political union and then entered a successful monetary union?

Professor Hughes Hallett: Plenty of countries have dissolved a fiscal union. I am trying to remember whether any of them entered a

monetary union afterwards, but my history is not good enough with regard to what happened with the small guys, by which I mean Monaco or San Marino. It is possible that that is true in those cases, but if—

The Convener: But you cannot think of any examples that have followed that model.

Professor Hughes Hallett: No, but you always need to start somewhere. The fact that there is no example to consider does not mean that I am not going to try something. I can work out what to do.

There are lots of monetary unions without political union, but I do not know whether they got there by dissolving something first. Mr Putin is making a good effort. There are cases in the Caribbean, and there is Belgium and Luxembourg, but I suppose that we could claim that that was because, after Napoleon, they broke apart and then ran a monetary union for a long time.

Oh—I have just thought of an example. When the Austro-Hungarian empire was dissolved, it left behind a monetary union between the Czech Republic and Slovakia. There was a long period of time between the two events, but it is a case in point. It was successful because the Czech-Slovak part was much the most successful bit of the Austro-Hungarian empire after the Hapsburgs departed.

The Convener: When Czechoslovakia itself divided, there was a monetary union between the two parts that, from memory, lasted five weeks.

Professor Hughes Hallett: Yes—it lasted a very short time, but that was their choice. There was no economic crisis. They merely chose.

The Convener: Okay. I bring in Chic Brodie.

Chic Brodie: Good morning, Mr Beveridge and Professor Hughes Hallett. It is good to see you again, Crawford.

I will go back to a question that I asked the previous panel. The Standard & Poor's report states that

"The Scottish economy is rich and relatively diversified".

It adds that Scottish wealth levels are comparable to those of several other countries, one of which is Germany. It continues:

"Even excluding North Sea output and calculating per capita GDP only by looking at onshore income, Scotland would qualify for our highest economic assessment."

Some people would say that our performance is significantly better than that of the rest of the UK, but it is certainly better. I keep getting confused about currency union and monetary union, but let me ask about currency union—

The Convener: Are they not the same thing?

Chic Brodie: No—not necessarily.

The Convener: Maybe our panel can discuss that later.

Chic Brodie: I know that you will have another meeting tomorrow. In your first report, you discussed four currency options, and you settled on a formal currency union between an independent Scotland and the rest of the UK. Why did you settle on that? Given the better performance of the Scottish economy compared with that of the rest of the UK, how was that decision arrived at, and how do you think the rest of the UK should look at it?

11:00

Crawford Beveridge: We went down that route partly because currently the economic cycles of Scotland and the rest of the UK are remarkably aligned, and there is a huge amount of trade between the two places. Scotland is the second-biggest trading partner for the rest of the UK.

There were several reasons for our decision. First, our view is that there is no reason to add the transaction costs of having separate currencies on the same island, when there is no need to do so. Secondly, from the rest of the UK's perspective, the significant sterling earnings in our oil and gas and our food and drink sectors would disappear and cause it significant balance of payments problems into the bargain. We concluded that, although we could certainly go with other options, they would all be more disruptive on both sides of the fence than the one that we chose, which is why we think it makes a great deal of sense for both parties to consider the option.

The economy looks strong, which is another reason why we would want to go down the formal currency union route. One of the concerns, which I think the convener was referring to earlier, is what will happen if there is an asymmetric shock because Scotland screws up in some miraculous way. However, all the indications are that the economy is strong and that we would not cause huge problems for our partner in a currency union.

There seems to be no point in saying, just because it is another option, that we will go off and form a Scottish pound in the first instance because that would give us many more degrees of freedom. As Andrew Hughes Hallett said, the degrees of freedom are somewhat limited anyway. From a business perspective, we think that it would give businesses great comfort to know that they would be in more or less the same currency and regulatory framework as they exist under today. Those factors drove us down this route.

Do you want to add anything, Andrew?

Professor Hughes Hallett: Yes. Perhaps I can help on currency union versus monetary union. The currency union is the one that I referred to as one-sided, because you do not have any input into the decisions that are made by the other partner. In monetary union, you have a little bit of such input.

The Convener: Just so that I am clear, are you proposing a monetary union?

Professor Hughes Hallett: Plan A involves a monetary union, in which there would be joint decision making on the bits that affect money: the Bank of England, interest rates and so on.

Chic Brodie: I will pursue that, because I did not realise that the proposed arrangement was bilateral. You refer to having "a little bit" of influence in a formal monetary union. We have talked about things that will affect the currency, such as the setting of interest rates. Given the current make-up of the monetary policy committee, what influence do you think an independent Scotland would have by having one person sitting on the board of—I think I am right—nine?

Professor Hughes Hallett: Yes, it would be one against eight; it would be one person out of nine. If there were severe disagreements, the one person would have rather little influence. However, there is no reason to suppose that in the normal course of events disagreement would be very wide because, as Crawford Beveridge said, the convergence—the cyclical correlations and the extent to which the economies are, in effect, the same on the monetary front—means that such disagreements would not happen often. The exception would be when there was a severe disagreement and there was a five to four vote—as happens on the MPC every now and again—and Scotland was the swing vote. Like Saudi Arabia when it comes to oil pumping, you can change the world at that point, but such situations would not arise often.

The other side of the matter, which it is important to think about and keep in mind, is that a flow of information about what is happening in the Scottish economy is going down to the Bank of England, which makes the interest rate decision. That may make a difference not to the voting but to the tone of the discussion and what is finally decided. You can hear proof of that if you speak to the governor of any national central bank in the eurozone; they do not control monetary policy, because they are a member of the committee that makes the decisions. They can try to influence the voting, which they may or may not be able to do. Germany has the biggest economy, but that is not reflected in its voting power, so it cannot do very much and it gets annoyed because of that.

The Dutch would tell you that what they have done in their central banks since going into monetary union is to double the size of their research departments, because they need to be able to say, "This is the state of the economy, as we see it, and this is what we recommend as being sensible, as we see it." It is possible to wield a lot of influence that way.

Chic Brodie: That is very encouraging.

I have one last question. I think that you touched on fiscal flexibility. I would like Professor Hughes Hallett to expand on that.

Given your background, Mr Beveridge, what do you think would be the impact on small businesses in the event of Scottish independence and harmonisation of the currency?

Professor Hughes Hallett: The currency is harmonised at the moment, so—following on from your last question—one would not expect major changes in monetary policy in terms of how interest rates would unfold. After Governor Carney's speech, I did a quick check on the degree of convergence. The usual thing that you would do, if you are talking about a currency union—I mean monetary union. I am going to slip up, too.

Chic Brodie: I am sorry. I should not have asked the question.

Professor Hughes Hallett: I know what I mean, but it is not necessarily what I say.

You would want rather small differences in interest rates—much less than a percentage point—so it would not be that but fiscal flexibility that would make a big difference. I am sure that smaller businesses would find that very helpful. It is entirely possible for Scotland, if it were to have its own taxes, to set them up in a way that would help smaller businesses.

I guess that it is outside this committee's remit, but if you want to get specific, you can get specific about what you might do with which tax to help which sets of businesses. One example would be to give effective assistance on research and development expenditure—for example, knocking it off corporation tax, or something of that kind—as an allowance. There would be flexibility. At the moment, we cannot do that. I would come at the matter from that point of view. You might be able to persuade the banks to lend a little bit more, too, but that is a different kind of thing. I guess that that would be done on the phone.

Crawford Beveridge: I do not think that it would make a huge difference to our small businesses in particular. Those that do a lot of business with the rest of the UK would find some comfort in this because for them, the transaction cost changes would be much larger than they would be,

percentage wise, for some of our larger companies. I think that small businesses on both sides of the border would welcome this greatly.

Margaret McDougall: Good morning. My question is on monetary union. We have heard that your plan A has been dismissed, if you like, by the Exchequer. What would your plan B be? We have heard that plan A is off the table—

Crawford Beveridge: Remember that we did not call it "plan A"; we called it a recommendation to the Government. Other people called it plan A. I do not think that any of us on the commission believe for a minute that the Chancellor of the Exchequer is serious, especially because as he thinks about himself and an election, there will be the cost of trying to explain to the thousands of businesses in the rest of the UK that do business in Scotland why they have to go through a transaction cost.

There is also the fact that the chancellor would have to figure out what to do about the loss in terms of the trade imbalances because of things like oil and gas and whisky. Further, there is the Treasury statement around the fact that it agrees that it would be totally responsible for the debt, and therefore need not necessarily require us to take any, which would give the chancellor another $5 billion a year problem. It is just like what we do in businesses: when there are opening salvos, we take positions, whether we are dealing with the labour union or with mergers and acquisitions. People take positions and—funnily enough—90 per cent of the time deals get done.

What gives us some comfort in that statement is that it was made on the advice of the permanent secretary to the Treasury, who built in some wriggle room. His letter says that he would

"advise ... against a currency union as currently advocated".

Like all negotiators, he has said, "Tell me a different way and maybe we'll have a chance to get this done."

In our report last year, we warned that there would be a lot of political statements in the lead-up to the referendum. However, in our opinion, the economics will trump the politics, and good heads will prevail if there happens to be a yes vote. We therefore would not want even to talk about a plan B at this stage of the game. There are lots of options but, at this moment, our strong advice to the Government is that it stick with the currency union. In the next few months, the fiscal commission working group will spend time trying to help the rest of the UK to understand the strong advantages of that and the strong disadvantages of deciding to go against it.

Margaret McDougall: Is that not a bit like sticking your head in the sand and saying, "We'll manage to negotiate something"? I would have thought that we should always have a plan B. Is there a preferred option?

Crawford Beveridge: That depends on one's negotiating style. If there is a strong reason to do A but you admit early on that you are willing to do B, you very much weaken the ability to keep pressing for A. Therefore, I just cannot see that happening. All our consideration of the other options always leads us straight back to plan A, as being the one that makes the most sense for both sides of the border.

I do not know whether Andrew wants to comment.

Professor Hughes Hallett: I can add a few things, which are slightly different in the sense that I do not do politics; I do economics. The point of that remark is that, in the past year, it is the politics that have changed, not the economics. If we offer advice and a recommendation on the economics of what is or is not sensible, that advice is unlikely to change until the economics change. In that context, it is important to accept that politicians often want things to be different from how they are, so they push a particular line. However, politics does not survive unless it is aligned with economics.

Students often ask, "What about the politics?" and it is a good question, but we should look at the examples of political affairs that have been screwed up because the economics went wrong. My favourite example is the Soviet Union, which screwed up for economic reasons, not political ones—although it took 70 years. Some people might not subscribe to this view, but the euro is another political operation that screwed up because the economics did not play along with what the politicians wanted. That became obvious the moment that France and Germany announced that they were not going to pay a fine for excessive deficits, because then the whole thing became incredible and people just overspent.

On Crawford Beveridge's observations about the get-out clauses in the permanent secretary's letter, I understood from Mr Osborne's speech that he said that there was no legal reason for agreeing to the plan A. To me, that suggests that he thinks that there are other reasons. I will try to put that into context a little. Earlier, I talked about a unilateral currency union, which is the one-way option in which Scotland, in effect, would just take the pound anyway. In that situation, Scotland would be in exactly the same position as we are in now, as far as monetary policy is concerned. The difference would be that, on independence, Scotland would have all the extra fiscal powers, so it would have to be better off, because it would

have all those extra instruments to promote its economy. It could decide to do that or not, but it would have the opportunity to do so.

From the rest of the UK's point of view—this is important—there is a cost of not being in plan A. That is, the rest of the UK will have exactly the same monetary policy as it has now—since nothing whatever on the monetary policy side will have changed—but it will have lost revenue and it will face the risk that fiscal policies in Scotland might have an impact south of the border and might not be to the advantage of the rest of the UK. Therefore, there is no question but that the rest of the UK will have to be worse off. There is a cost to not agreeing to plan A. Before the referendum, those in the rest of the UK are unlikely to talk about that but, after the referendum, if they are sensible, discretion will be the better part of valour.

I have, I think, seven options for other plans that could be followed, although we do not recommend them. If we go through the logic of them, they all lead to the same conclusion, which is that Scotland will be better off to varying degrees—I have taken the most obvious example of that—but the rest of the UK could be worse off. There is a cost to not being in a monetary union.

11:15

Margaret McDougall: I do not agree. We have a currency agreement at present, as you said, and we have influence, whereas in an independent Scotland under a currency union or sterlingisation we would have no influence.

We heard from the earlier panel that Scotland having its own unit of currency would be the best way forward. Do you disagree with that?

Crawford Beveridge: Essentially, yes I do. We looked at that option closely, and obviously we will continue to look at these things to see whether the economics change, as the fiscal commission meets. At present, as Andrew Hughes Hallett said, we do not see any economic evidence that would change our view that the absolute best thing for both parties would be monetary union.

Professor Hughes Hallett: I question how much influence we have under the current regime. Mervyn King said when he was governor of the Bank of England—I do not have the quotation with me—that he would not do anything to change policy in order to help Scotland. That seems to be a fairly clear statement that we do not have any influence.

The Convener: Richard Baker has a supplementary question.

Richard Baker: Mr Crawford, many people who are watching this evidence session will take the view that not believing that the chancellor is serious is simply not a strategic approach to a very important issue. Any business will, in examining a proposition, always have a plan B if something goes wrong with the preferred option.

Professor Hughes Hallett has just said that the commission has looked at several alternatives. Would not it be sensible to present to the people of Scotland what you believe to be the preferable alternative from those options, if we conclude that the chancellor is serious, which in all likelihood he is?

Crawford Beveridge: We will continue to express to Government our view on the best option, which we still think is union. The committee should remember what we are doing here—we are not setting the politics; we are doing only the technical end. If the Government wants to go ahead and say that it is going to pick one of the other options as a back-up, that is entirely for it to decide.

Richard Baker: So you have supplied those options to the Government.

Crawford Beveridge: There were four separate options in the report that we produced one year ago. We strongly support the view that the sensible option for the Government to follow is the one that we have proposed.

Alison Johnstone: Good morning. Previous expert witnesses have suggested that if we were to have a monetary union without a political union, there could be risks for the rest of the UK because an independent Scotland could, if it did not like the way things were going, just pack its bags and leave the monetary union. Is that a likely scenario?

Crawford Beveridge: Macroeconomic systems change over time; I would never say never to anything. The history of the UK—going through the exchange rate mechanism, thinking for a while about whether it ought to be able to join the euro and putting up certain tests for being able to do that, and the Bank of England becoming independent and going for forward guidance and so on—shows that the macroeconomic framework changes.

We are simply saying that, for the foreseeable future, as far as we are happy looking forward, there is no particular evidence that getting up one morning and saying, "We're going to change this and go into a Scottish pound," is likely to happen. Ireland, for example, used the pound for 50 years or thereabouts before it decided to use the punt, which it used for several years before joining the euro. Something changed in the Irish environment that told the country that it ought to make a change. I have no idea what that could be for us, but it is certainly far enough out that we cannot see anything in particular going wrong.

To go back to the issue of whether Scotland could cause serious disruption, one causes disruption not just for oneself but for somebody else if one makes sudden decisions about things. Anything that we would do would presumably be thought through well in advance, and negotiated with neighbours and worked out in some sensible way. One does not just wake up in the morning and say, "Let's have a Scottish pound instead."

On the other options, I remind you—and Mr Baker—that no cataclysmic event will happen on 19 September. We will not suddenly get there and say, "Oh my goodness, we have to change currency today!" There will be a long period of negotiation and, with respect, I believe that, during that period, we will hear a different set of views from Westminster from the ones we hear today. If we are wrong, there will be a couple of years in which we can go off and decide what we want to do that is different.

The agreement that was signed in Edinburgh said that the two parties would want to enter into amicable and constructive agreements with each other. I just cannot believe that, out of sheer spite, somebody would say that they were not going to enter into an agreement along those lines.

Alison Johnstone: Thank you. Do you have a view on that, Professor Hughes Hallett?

Professor Hughes Hallett: Yes. The implication of your question is that, if we are in a political union, we are locked in even when it goes against our own interests to be so. If we are in a monetary union, because we do not have the lock, we have to pay attention to whether it is in everybody's interests; otherwise something will happen. It tends to produce much better results because it makes us co-operate as opposed to telling people what to do.

Your point about changing the regime is not restricted to the political union. Within the political union that exists, the fiscal regime has changed every 10 years in my professional life and somebody uncharitably pointed out to me yesterday that the tax regime in the North Sea has changed 16 times in the past five years or something. Such things happen all the time. A political union does not knock it out.

Alison Johnstone: Thank you very much for those answers. Which constitutional settlement is most likely to develop an economy that closes the dreadful gap between the rich and poor in Scotland?

Crawford Beveridge: That is a little beyond the remit of the fiscal commission working group, I am afraid. I am not sure that I want to get into that territory. However, on a purely personal basis rather than dragging my colleagues into it, I am a little disappointed in the debate. Although the economy is important and the choice of currency will be important, we have missed the point that the reason for having good, strong economies is to try and form the kind of society in which we want to live.

We are not spending nearly enough time talking about the fact that the current policies by which we live are causing greater and greater inequality—large numbers of people in poverty—and that is not being appropriately addressed. Under any constitutional structure, such issues must be thought through. As you know, a little earlier than it produced its white paper, the Government produced economic policy choices for Scotland in a different paper, which suggested that it would go down different paths to sort out some of the issues with how we bring all the people back into the system.

However, it is a little beyond our remit to make such decisions.

Alison Johnstone: Professor Hughes Hallett, do you have a view on how the taxation system could be improved to address those inequalities?

Professor Hughes Hallett: I am sure that we can come up with answers on that. Professor Mirrlees has been spending his entire life talking about that and getting Nobel prizes for it.

Redistribution is a hell of a lot easier if a country has its own tax system and is not locked into somebody else's. It can use the tax system to promote growth. That might widen the inequality gap, but it might also be done in such a way as to close it—look at Scandinavia—and back up other redistribution plans by getting more people into work, for example.

Mike MacKenzie: I have a question for Professor Hughes Hallett. In the first panel of witnesses, we heard from Angus Armstrong. What is your view on the National Institute for Economic and Social Research analysis on debt?

Professor Hughes Hallett: That is a good question. Do you have a couple of hours?

The Convener: Sadly not.

Professor Hughes Hallett: I presume that you are referring to the institute's concern that the possibility of debt creates a risk premium on interest rates, which would make the performance of the economy worse—there would be an effect on investment, future growth and so on.

I have looked at that paper and have thought about it a little bit, and there are a number of things about the way that the analysis has been done that I am not happy about. This is a bit technical. There are always two parts to the risk premia on interest rates, which is why I use the plural "premia". First, there is the currency risk,

which is the risk that the currency will depreciate—that inflation will build up or whatever as a result of monetary policy. Secondly, there is the default risk, which is the risk that the Government will not be able to pay back its debt. Unfortunately, because of the way that the institute ran its analysis, the paper includes explanatory variables to tell you how the risks work only from the debt and deficit side—there are none from the fiscal side. The institute does not worry about the currency risk side, which means that those variables have to work twice as hard in order to explain both parts, which gives an exaggerated effect. That is a problem.

I cannot rerun the institute's analysis because I do not have its data or anything, but I can check its predictions against what has actually happened in specific cases. For Scotland, everything is done in ratios of what Scotland's fiscal position would be relative to the UK. We can then look at a comparable case in which the ratios are the same but within the eurozone—this is just for the default risk part. For example, Austria's ratios to Germany are exactly the same as Scotland's ratios to the rest of the UK, almost to the percentage point. The model predicts a risk premium of 4 per cent for Austria, but it is actually 0.4 per cent at the moment—so the prediction is 10 times wrong, if I can put it that way. The model also predicts a risk premium of 8 per cent for Japan although Japan's interest rate is 1 per cent lower than Germany's. The predictions are way over the top. The institute needs to conduct its analysis in a different way. There are other analyses out there that look at such things using a much wider set of explanatory variables. Typically, the fiscal variables do not have much impact except in severe crises, so you will see them coming in around 2009-10. It is to do with liquidity in the markets and coefficients of risk aversion—I am sorry for using technical language. There are lots of other variables that I could cite, including trade imbalances and that sort of thing.

Crawford Beveridge: Are you sorry that you asked now?

Mike MacKenzie: No, not at all. The thing that will stick in my mind is the description of the predictions as being "over the top".

What do you think about the Treasury analysis that was published just before George Osborne's announcement that we would not get to keep the pound? In particular, what do you think about how risk is calculated in that analysis?

Professor Hughes Hallett: That is another paper that I looked at. I should explain that I am looking at these papers because they immediately abut my own academic work. I looked at the model that was used in that paper and have various points to make about it. I am sorry—this will take another hour.

The model is based on—how can I put it?—a fixed steady state whereby, in the long term, the economy will always have the same set of numbers. That is what the Treasury has used to calculate the risk and, hence, the interest rates. No growth is forecast in the economy. Much more worrying, because those risk premia are going to come from the fiscal side for deficits and debt being too large, there is absolutely no fiscal policy in it. If the model was accurate, there would be zero that you could do to get your deficit and debt down, and that does not seem a very sensible way to go about it. You might as well go home and go to bed, because there would be nothing that you could do.

I then got excited and looked at how the Treasury introduces the risk premia that affect the interest rates. There is only one risk premium in the entire model, and that is for Scotland. The other three economies—the rest of the UK, the rest of Europe and the rest of the world—do not attract risk premia at all. It is impossible for them to have a problem—it is only possible for Scotland to have a problem. [*Laughter*.]

11:30

On top of that, the way in which the Treasury calculates the deficits—I hope that I get a laugh for this, too—has three components. There is the structural deficit, which is the long-term deficit. On average—not every year—that is fixed at some number, which you cannot get away from. There is the cyclical deficit, which, on average across the cycle, is zero. There is also the contribution from oil revenues, which will be positive. The other two deficits are negative. According to that model, the only country that has a chance of getting out of having a deficit is Scotland, because if oil prices go up a lot, the positive will begin to outweigh the negatives.

Crawford Beveridge: I interpreted all that as, "They fix the numbers."

Professor Hughes Hallett: To put it another way, I would not let my students—even in first year—get away with that. My bottom line is that the Treasury needs to look at its recruiting policies.

Mike MacKenzie: Thank you very much. What will stick in my head is Mr Beveridge saying, "They fix the numbers."

The Treasury has suggested that the banking sector is worth 12.5 times our national income. Would you care to comment on that?

Crawford Beveridge: We have taken a long look at that and it is simply not correct. It is another occasion on which the numbers do not reflect reality for a number of reasons, one of

which is that the Treasury did not take into account where many of the big banks—RBS particularly—have some of their investment banking activities. It was a very backward-looking view, which was probably correct at the time that the Treasury looked at the situation. Looking forward, we see that reforms are going on such as EU reform of banks, the Vickers reforms and the Basel Committee on Banking Supervision reforms. If we analyse those things, we get a very different set of numbers that are very much in line with the numbers in the rest of the UK. We should not look backwards and project things; we need to look forward to what changes are going on in the banking system and understand the numbers in that way. Is that fair?

Professor Hughes Hallett: That is fair. The point that Crawford makes is that this will happen automatically. The Vickers reforms will be introduced and a banking reform act—I cannot remember its exact name—was passed in December 2013 in London. That will cause what Standard & Poor's was pleased to call in its report "redomiciling". In other words, with the way that the accounts work, if the banking sector is worth 12.5 times our national income, a proportion that is 11 times our national income will be reallocated to London.

Crawford Beveridge: There might be a very different number. Recently, HMRC created an experimental series of tax revenue statistics. It estimated Scotland's share of the bank levy, which is a charge on the banks' balance sheet, to be 7.3 per cent of the UK total, which is a sharp contrast to the almost 25 per cent that would be required to meet the Treasury's number. A lot more serious analysis needs to be done there.

Mike MacKenzie: Thank you very much indeed. That is very useful.

The Convener: We are a bit behind the clock, so we need to sharpen up our questions and answers.

Joan McAlpine: Mr Beveridge, you said that you do not think that anyone on the committee believes that the chancellor was serious in his speech about currency union and Scotland's right to share the pound. Would you extend that to other UK politicians who have made the same comments, such as the shadow chancellor?

Crawford Beveridge: It was a little curious that it all happened at the same time. There was an unusual degree of co-operation among the political parties, which was interesting.

I may be being too harsh on the chancellor to say that I do not believe him. I would rather say that all of us expected and indeed put in the report that politics would prevail up until the time of the vote and that we would see political, not economic, statements during that time. I believe that if people were serious about reasonable and amicable negotiation when they signed the Edinburgh agreement, we might see a very different discussion if there is a yes vote. Because the economics are so sound, that would be the case whether we had a Labour Government or a Conservative Government in power in Westminster. Whoever says that we would not have a currency union is giving you a political, not an economic, view.

Joan McAlpine: Quite a lot has been said about your Nobel laureates. One of them, James Mirrlees, was quoted by the governor of the Bank of England, Mark Carney, in his speech when he came to Edinburgh a few weeks ago. Given the prestige of your committee and Mark Carney's admiration for it, what discussion has the UK Treasury had with you? I take it that the Treasury will have got in touch with you to discuss your report.

Crawford Beveridge: Alas, no. We have tried hard to engage the Treasury and others on these matters, but they do not want to have those discussions prior to an independence vote taking place. That is in marked contrast to the Bank of England, which has been willing to open discussions with us—not with us personally, but with our representatives. A great deal of discussion could usefully be done in advance, but I can understand the negotiation position that says, "We don't want to talk about this theoretically. We will talk to you about it only when it is practical."

Joan McAlpine: I return to the point that you made about the letter from Nick Macpherson, the permanent secretary to the Treasury, to George Osborne, in which he said that he would not advise a currency union "as currently advocated". You described that as wriggle room. What do you think he meant by "as currently advocated"?

Crawford Beveridge: As I was trying to say before, it was clever language of the kind that I would expect good negotiators to use. It allows them to say, if they want to come back into a negotiation, that they never said that it could not be done—only that it could not be done as currently advocated. If we can negotiate around how things might change, there could be an opportunity to do that.

I do not know how many of you listened to Peter Curran on the radio last Saturday morning, but he was talking about negotiation skills and he would tell you that all good negotiators leave themselves a little space so that, when reality starts to bite, they do not have to lose face but can explain things in an entirely different way.

Joan McAlpine: Thank you very much.

The Convener: I seem to recall that I have debated with Mr Curran on that point.

Crawford Beveridge: I understand that, and I read the transcript with great joy. Well done.

Richard Baker: We have heard from Crawford Beveridge about the hit-it-and-hope approach and its preferred currency option. Professor Hughes Hallett, you have previously said that you thought that an independent Scotland in the European Union would at some point in the future be required to join the euro. Is that still your point of view, and to what extent do you think that euro membership might ultimately offer an alternative currency option for a separate Scotland in the medium or long term?

Professor Hughes Hallett: It certainly could offer an alternative in the medium to long term. As I said, I had a list of seven options and that is one of them, but it is not the one that I think is most suitable. I have run the numbers in the tests for whether Scotland is a good candidate for a currency union or a monetary union, with the UK or with the euro, and at the moment it is far better for it to be with the UK. Scotland satisfies those criteria much better, so there would be much less asymmetry and fewer possibilities of things going wrong if you were to go with the pound.

If London slams the door shut totally, so that you have to think of something else, the euro is one of the many options that you could try, although it is not necessarily the one that I would recommend. I have not ranked them, and I would not do so, but our report states that that is a possibility. The Treasury's report of April 2013 also listed those things, and that is one point on which we are at one with the Treasury.

Richard Baker: Do you believe any longer that joining the euro would be a requirement in two, three, four or five years' time with European membership?

Professor Hughes Hallett: No. It is difficult to explain but, as I understand it, this is not a treaty requirement but an agreement. The force behind it is different. It is expected that European countries will join the euro, but you can see that some of them do not. Sweden is the classic example. It was told that it had to be in the euro and that it had to be in the exchange rate mechanism too, which is one of the conditions for getting into the euro, but it did not do so. It is voluntary, and nobody can make Sweden do it, and nobody has complained that it has not done it. It is one of those wobbly things in the euro system.

Richard Baker: I will not extend the debate on the European treaties and the details of their impact. I shall leave it at that.

Marco Biagi: What has been the practical impact of the UK Government's announcement that it is legally liable for all its outstanding national debt?

Crawford Beveridge: A practical possibility is that, if Scotland felt that it was not being negotiated with reasonably, it would have no actual liability. Christine Bell, who is a constitutional law expert at the University of Edinburgh, has said:

> "Legally under international law the position is clear: if the remainder UK keeps the name and status of the UK under international law, it keeps its liabilities for the debt. The UK took out the debt, and legally it owes the money. Scotland cannot therefore 'default'."

The whole point of the Edinburgh agreement was that we were not going to stand by what was legally here or legally there; we were going to sit down and amicably agree what we ought to do. Christine Bell's statement is one of the reasons why I think that whoever the chancellor in power at the time is will want to sit down and talk to us reasonably about other aspects as well.

Marco Biagi: One of the reasons why the UK has such a large national debt is the UK's economic management during the past 17 years. How do you think that the UK has done in managing the so-called fiscal rules under Labour or under the Conservatives?

Crawford Beveridge: I will defer to Andrew Hughes Hallett on that, if he wants to answer it. It is way beyond the remit of the group that I chair.

Professor Hughes Hallett: Over the years, there has not been much in the way of identifiable formal rules. In the 2000s, there was an implicit rule—it was an understanding rather than a formal rule—that debt would not be more than 40 per cent of GDP. However, because of the impact of the recession and, as my Scandinavian academic colleagues will tell me, the fact that Britain at that point was not well prepared for a downswing as it was already in deficit and badly placed to withstand it, the position got much worse, so the 40 per cent rule went out of the window.

There was also a rule called the golden rule, which says that you balance current spending across the cycle but borrow for capital investment purposes. That was part of the set-up as I understood it, and it is still part of the set-up in Germany, so it is a reputable rule. However, it disappeared as well.

Whether we are talking about the rest of the UK or Scotland, we need to get back to having some sort of firm idea of those rules. If we had another hour, I would explain exactly what I mean. I am just making the point that we need the rules.

The important thing about the rules is that, if we have them, they must be seen to be obeyed if they are to be credible. It is the same as dealing with your kids. If they misbehave and you just say, "If you are naughty again, I won't like it," is not going to achieve very much. The rules have to be seen to be obeyed.

Marco Biagi: I believe that the current Conservatives have a pair of rules that are slightly adapted from those of Labour. One is that they should get back to the five-year cycle of borrowing only to invest, and the other is that the national debt should be falling by 2015-16. At least, that was the chancellor's intention at one point. I take it that, in your estimation, there is little chance of that.

Professor Hughes Hallett: No, and the problem with those rules is that they are quite specific to the current situation. That is not silly; we need to get out of the current situation. However, they are not rules that you would put in place for ever more, because they would not mean anything. I would work out quite a different set of rules, and make sure that they focused on debt rather than the deficit. What makes people go bankrupt is not being able to service their debt.

The Convener: On the question of debt, when the Scottish Government came out and said that if there is to be no monetary union with the rest of the UK, we might not take responsibility for our share of the debt, was that based on fiscal commission advice?

Crawford Beveridge: I cannot answer for what was in the Government's mind when it did that. It was not in our report but, at that stage, it never occurred to us that there would not be genuine and reasonable negotiation. We had not anticipated that Treasury statement. As I said, there is still room on both sides to step back from such statements and come to some agreement.

The Convener: In the view of the fiscal commission, would it be wise to take that approach?

Crawford Beveridge: That is really a political decision that will have to be made as part of the negotiations that are to come. From what the constitutional lawyers say, it sounds as though it is well within the rights of the politicians so to do, but they need to be left to negotiate on their own. We are just tinkerers at the edges.

The Convener: Dr Armstrong told us earlier that he thinks that substantial risks are attached to that approach.

Professor Hughes Hallett: You will need to expand on that. What risks are you referring to?

The Convener: I am referring to the view that the international monetary community would take on an independent Scotland that had not adopted a share of UK debt.

Professor Hughes Hallett: That is a possibility, but one that is overblown. There are lots of studies of countries that have defaulted in the normal sense, but we are not talking about an outright default here. For example, Argentina defaulted in 2001, but it was back in the markets shortly afterwards. I would not get too worried. It is not that the point is wrong; it is just that you can overemphasise it.

11:45

Crawford Beveridge: You need to remember that this would not technically be a default, and it would allow you to start your economy with essentially no debt, which would probably help the markets dramatically.

Christian Allard: Good morning. I have a couple of quick questions. I agree with Crawford Beveridge that a yes vote is about a lot more than currency. What about taxation? Could we run a more efficient system after a yes vote?

Professor Hughes Hallett: I can try hard to answer. That is in part an administrative question. We discovered in last week's Finance Committee that neither of us has ever run a tax system, so we do not know how the computer does it, as it were. The answer must be yes. Other countries run tax systems; if they can do that, we could do that, too.

An OECD report—I have forgotten which year it is from; it was 2008 or thereabouts—pointed out that per pound of tax taken in, it costs Finland and Norway something like 60 per cent of what it costs HMRC to run the UK tax system. Were I asked to answer that question in reality, a quick trip over there to ask how they do that would pay enormous dividends. Running a tax system more efficiently can obviously be done.

Crawford Beveridge: I will repeat a comment that we made to last week's Finance Committee when we were asked specifically about the taxation changes under the Scotland Act 2012. Our response—to which I am sure that Sir Jim Mirrlees would agree—is that you should not start just with tax but start with the society that you want to build and what you are trying to achieve, and then figure out a tax system that would achieve that effectively and efficiently. That is very easy to say and probably extraordinarily complicated to do, but that is the right place to start and you would have an opportunity to do that.

Christian Allard: Thank you for that answer. My second question is also about currency, and it relates to what happened at the beginning of the year. We have talked about when the Treasury decided to come out and say that the UK

Government would take sole responsibility for all UK debt, which it said that it did under pressure from the markets. You have commented on the monetary union. Could the markets not put the same pressure on Mr Osborne before the referendum so that he changes his mind?

Crawford Beveridge: The Treasury said that in part because many holders of Government debt are not in the UK—some are in the UK, but a lot are outside the UK—and they needed some assurance that a certain proportion of their debt would not be moved suddenly to somebody they had never dealt with and that the legal liability for the debt would remain with the person who had the debt in the first place.

Could the markets look again at the situation? Nothing would change. Even if we took on the debt, it would be in such a form that the Treasury would still be responsible for it. We would simply have an agreement with it that we would pay a portion of the moneys that were due on that debt. It is only when that debt starts to retire and we start to float our own bonds that you would have a different discussion about what the market would want to do with you. However, voting yes or no would not change the liability for the debt.

Christian Allard: I was trying to make the point that the markets made the Treasury change its mind. Perhaps the markets could place pressure on the Treasury to change its mind on this as well before the referendum if they, like you, think that monetary union would be better for both sides.

Crawford Beveridge: I think that that would be unlikely.

Professor Hughes Hallett: The markets might say something like they preferred plan A. The markets would prefer that because the situation would be more stable and would lead to a better economic performance both sides of the border—they would quite like that.

As far as debt and the other problems are concerned, what worries the market more than anything else—this can be seen in the Standard & Poor's report—is growth, or the lack of it. As you would expect to get more growth out of the proposed monetary arrangement simply because it is co-operative and people would try to get the best out of it for both parties, they would probably prefer that. There might be implicit pressure, but you would not be able to see it very easily in an indicator.

The Convener: If there were going to be an adverse market reaction, surely we would have seen that immediately after George Osborne's speech.

Crawford Beveridge: That is right.

The Convener: There are no more questions, which is good because we are out of time. I thank the witnesses very much—your evidence has been extremely helpful to the committee.

I suspend the meeting to allow a changeover of witnesses.

11:50

Meeting suspended.

11:57

On resuming—

The Convener: I welcome our third panel. Professor Charlie Jeffery is professor of politics at the University of Edinburgh and director of the Economic & Social Research Council future of the UK and Scotland programme; Professor David Simpson is an economist and author; and Professor David Bell is from the University of Stirling and a fellow of the ESRC future of the UK and Scotland programme.

In view of the time, I will not ask for opening statements. We will just go straight to questions. It would be helpful if questions and answers could be short and to the point. I ask members to direct their questions to a particular panel member. If a panel member wishes to answer a question that has been directed at somebody else, they should just catch my eye and I will bring them in as time allows. We hope to finish by 1 o'clock.

The currency issue dominated the previous two panel sessions—some of you may have seen some of those exchanges. In the first panel session, Dr Armstrong and others said that a monetary union with the rest of the UK was not in the rest of the UK's interests, and therefore the stance being taken by George Osborne and his counterparts was a rational one. In the second panel session, I quoted comments from Professor Paul Krugman that express concern about the monetary union model. The fiscal commission working group, of course, defended its own position on the issue, and the chair, Crawford Beveridge, told us—if I am him quoting correctly—that the approach to the monetary union model was being taken out of spite.

Where do you stand on the issue? Is it rational for the rest of the UK to say that there should not be a currency union?

Professor Charlie Jeffery (University of Edinburgh): I will take a rather different perspective in answering that question from the perspective that my colleagues might take. I am a political scientist, not an economist.

12:00

In exploring the way in which the two sides in the debate and the two Governments are presenting the issue, it is important to understand what they both mean by independence, as the word means different things to each Government. The Scottish Government's vision of independence involves strong continuing relationships with the rest of the UK in all sorts of fields, of which currency union is the most prominent.

The UK Government's conception of independence, which we see running in parallel with its thinking about the UK's relationship with the European Union and internally in the Scottish debate, is that real independence—that is my terminology; one might say "classical independence"—involves states running their own currencies and doing all sorts of things on their own that the Scottish Government envisages will be done in continuing collaboration. Understanding those different starting points is important in understanding where we are in the debate at present. The issue may not be so much a question of interests, but more a question of fundamental understandings and philosophies of statehood.

Professor David Simpson: It seems that the arrangement that the Mirrlees commission has proposed represents continuity and not much change—in other words, just carrying on as we are. We all know how much businesses dislike uncertainty, and continuity represents certainty. That is my first point in favour of a monetary union.

Secondly, the landscape of financial regulation is changing every year, and cross-border co-operation is becoming ever more prominent. In the latest example, the UK Government is discussing supervision of banks with the US Government with a view to establishing some formal degree of co-operation shortly. In that context, it seems a little strange to hear that the UK Government is unwilling to envisage cross-border co-operation with an independent Scotland.

Professor David Bell (University of Stirling): I will answer the convener's question from a specific angle. Last weekend my son introduced me and my wife to the Myers-Briggs test, which is a way of deciding how someone's character is balanced. I came out as cold and unemotional. [*Laughter.*]

I have spoken to a number of audiences about George Osborne's discussion of whether a currency union would be acceptable, and I have seen a variety of emotional responses with which—as a cold-blooded economist with an interest in game theory—I have found it quite difficult to empathise. I look at the issue in a cold-hearted way. There is clearly a case for continuing a currency union with regard to transaction costs; that is one side of the story.

The other side concerns the associated risks, which would lie with the larger of the two partners, because it will not ever be the case that Scotland could bail out the rest of the UK. David Simpson was talking about the risk that would be posed to the liquidity of the banking system, and it seems that we would pretty much have to have a banking union.

However, on the fiscal side, there is an issue. An optimal currency area is effectively defined by where fiscal transfers take place. If a shock such as an oil price collapse were to hit Scotland, how would the UK Government deal with that at present? It would make transfers, taxes would fall in Aberdeen while unemployment benefit costs rose and so on. Post-independence, those fiscal transfers would not take place.

The question then becomes one of the nature of the agreement that the RUK Government and the Scottish Government would have to make on the currency union; whether such an agreement could be binding; and what type of commitment the Scottish Government could make that would be credible in RUK's view. That is a critical issue, because we have seen such agreements made in good faith round a table such as this one disintegrate in the debt markets. I am not saying that such an agreement could not happen, but from the perspective of an RUK Government there could be a fairly significant downside.

The Convener: I will bring in Chic Brodie in a moment, but I have one follow-up question on the currency issue, which I put to the previous panel. Are you aware of a historical model in which a political union has been dissolved and a successful monetary union put in place?

Professor Simpson: I am not aware of one, but I am not a historian. I do not know that the dissolution is necessarily a relevant factor; what is much more important is whether the structures of the economies are similar and whether there is significant labour mobility between them. Those are the traditional indicators of whether a monetary union is likely to be successful.

Of course, as David Bell indicated, the countries involved must have agreed on the rules of the game and be confident that people will stick to them. However, I would be astonished if, in a two-country monetary union such as one between Scotland and England, there would be a problem of bad faith, shall we say. That has happened in the European monetary union, which is a 17-country organisation. Governments make blithe promises and are fairly secure in the knowledge that they will not be held to them, but I do not think

that such a problem would arise in negotiations between Scotland and England.

The Convener: Okay.

Professor Simpson: That is for the obvious reason: it is not because we are perfectly virtuous, but because there would be countervailing sanctions

The Convener: I am encouraged by your faith in the honesty of politicians.

Professor Bell: I do not know of any historical examples. One example that is often quoted is the Czech-Slovak situation, in which there was a loose commitment to go to separate currencies after a period of time—I think that it was six months or so. However, the markets anticipated the move, of course, which caused the breakdown of the currency union in a matter of weeks.

It is worth pointing out that, if we look at the way in which the Scottish and UK economies have behaved since the 1980s, we can see that Scotland has tracked the UK economy as a whole better than any other part of the UK. In David Simpson's terms, that means that we have the same cycles and would not be subject to differential shocks. There would not be a particular disaster in Scotland without the same sort of event occurring in the rest of the UK.

However, Professor Ronald MacDonald of the University of Glasgow has made the point that, although in essence we have had the same cycles, Scotland would be more exposed to oil price shocks than the rest of the UK ever has been because oil is a much larger part of the Scottish economy.

The Institute for Fiscal Studies report that came out yesterday and the modelling that was done in the white paper, "Scotland's Future: Your Guide to an Independent Scotland", give perspectives that are radically different—by around £4 billion or £5 billion—on where oil revenues will be in about two or three years' time. That is a big gap if the total spend is about £60 billion. We are talking about one fifteenth, or 6 to 7 per cent, of total public spending. There is a difference of opinion about it at the moment, but that factor could be reflected if the price jumped about.

Chic Brodie: In most of our discussions, the financial sword of Damocles seems to hang over Scotland with regard to an oil collapse. Five or six years ago, it was the financial sector—the banks—that effectively collapsed. I wonder whether the panel can help me with this—I am not sure whether it is a myth. We are still apparently talking about bank bailouts, notwithstanding the regulations that are supposed to be applied through Vickers. My question is for Professor Simpson, who gave us an excellent paper. Exactly who owns the banks' assets and liabilities? We have spoken about Scottish banks but, effectively, they are not Scottish, are they?

Professor Simpson: No, they are not. I do not know the answer to your question. I do not know who owns the—

Chic Brodie: The assets and liabilities do not fall in the country in which the banks operate.

Professor Simpson: Nominally, the shareholders are responsible for both the assets and the liabilities. I said a moment ago that the landscape of financial regulation is changing. One of the important aspects of that relates to the shift from bailout to bail-in. When the Royal Bank of Scotland collapsed in 2008, there was no alternative but for the taxpayer to pick up the tab. The UK Government did not have in place what is called a resolution mechanism for dealing with the failing banks. Such a mechanism is now being put in place, not only in the UK but in Europe.

In future, there should be no claim on the taxpayer, or at least any claim should not be of the extent that we have seen. The much more important point is that the purpose of the bail-ins is to give the owners—the shareholders—the creditors and the management an incentive to behave prudently. In the run-up to the 2008 crisis, all the incentive went the other way. All the directors of all the big banks had an incentive to behave as recklessly as possible, because they knew that, if they were successful, they would make a lot of money for their shareholders, and if they failed, somebody else would bail them out, which is what happened.

Professor Bell: A couple of the banks are, in large part, owned by us, but the shareholding will possibly be spread worldwide. Pension funds will hold a large chunk of it.

I suspect that I learned this lesson from David Simpson some time ago but, in general, it is important to think of the head office, the ownership of a company, its operations and its shareholders as possibly being located in different places. There is no reason why they need all be coincident. In Scotland, we have major employers in the financial services sector whose headquarters lie outside Scotland, along with responsibility for financial management. I am not referring to a retail bank, but to other kinds of operation.

Chic Brodie: That clarifies things. We could perhaps continue to move the debate away from an oil collapse and its impact on the Scottish economy. I hope that we never again face such a bailout of the banks, the majority of which operate out of London and internationally.

I have one question for Professor Jeffery. Clearly, the debate is important for Scots, but it is

wider than that and is about what Scottish independence means not only for the rest of the UK and Europe but globally. As a political economist, are you disappointed that the Opposition parties have been unable to make any genuine guaranteed offer on more powers coming to the people of Scotland in the event of a no vote? In fact, the leader of the Conservatives in Scotland has stated that there will be no agreement before the referendum between the three anti-independence parties. Is that short-changing the Scottish people?

12:15

Professor Jeffery: I certainly would not say that I am disappointed, because it is not my place to personally offer my approval of those parties or to express my disappointment with them. The Liberal Democrats have set out a proposition for what they call home rule, which is an extended form of devolution. The other two main parties in Scotland are considering the issue, and we should hear from the Labour Party in a couple of weeks.

I will move away from the terrain of disappointment and towards the terrain of tactical logics, which I covered in my written submission. I draw attention to the mythical median voter in Scotland: the voter who stands right at the middle of the spectrum of opinion and whose support needs to be won in order to create a majority. It is clear that the median voter in Scotland is in the devo-max category, or at least the devo-more-than-now category.

In that sense, I can see a strong tactical logic for the Liberal Democrats, Labour and the Conservatives to have an offer in place. We shall see whether that offer comes and whether, if it does, it is co-ordinated. The two parties that have not yet published on the matter are having robust internal debates, and we look forward to seeing how those turn out.

Chic Brodie: Of course, we know that there will be no agreement between them before the referendum.

I will leave it there.

The Convener: Alison Johnstone wants to ask a quick supplementary.

Alison Johnstone: It is a supplementary to Chic Brodie's first question. If, as Professor Simpson said, we are seeing a shift away from the idea of bailouts by the taxpayer to bail-ins by the management, shareholders and creditors, why is the argument about who would bail us out in a disaster being used as an argument for retaining the status quo? I ask Professor Simpson to elaborate on that.

Professor Simpson: In much of the discussion, people have not grasped the fact that there is a movement from bailout to bail-in. Once that has sunk in, people might begin to realise that the question of a lender of last resort is another smokescreen—perhaps that is the wrong word, but there is a misapprehension about it. Until 2007, the lender of last resort meant that the central bank, which in our case is the Bank of England, would be willing to temporarily lend money—or, to use the jargon, liquidity—to solvent banks that had good collateral. I emphasise that they had to be solvent. That principle of lender of last resort has been completely lost and, instead, the idea of lending to banks that are not solvent or are bust has come more to the front. Such banks might not have good collateral or they might have no collateral at all.

That has been the big problem that all Governments have been wrestling with for the past three, four or five years. Part of the answer is that the movement to a bail-in will, as I said, change bank directors' incentives, but there will also have to be much more intrusive regulation. I am sure that everyone is familiar with the anecdotes about what went on in the banks in the run-up to the collapse. That should never have been allowed to happen.

I worked for a life insurance company for a while, and I cannot remember hearing of the collapse of a life insurance company. I believe that one reason for that is that, every year, life insurance companies had to publish the most intrusive details of their transactions. Those were not just for the Department of Trade and Industry to see; they were for everyone to see so that everyone knew what was going on. Perhaps that sort of regulation is needed in retail banking as well.

The Convener: I am a policy holder with Equitable Life. You have touched on a very sore point.

Professor Simpson: I believe that I am right in saying that Equitable Life did not become insolvent; rather, the expectations of some of the policy holders were disappointed.

The Convener: That is a very fair assessment.

Professor Simpson: I think that the blame for that should be attributed to the House of Lords, which came up with a bizarre judgment.

Chic Brodie: And the Rangers support.

Joan McAlpine: I have one question for each panellist. I will start with Professor Jeffery.

You talked about more powers and the possibility of the other parties agreeing a package before the referendum, although you did not sound terribly optimistic that they would do so.

Hypothetically, if more powers were on the table, one argument is that that would open the door to an end of the Barnett formula. Do you see the Barnett formula lasting if there is a no vote?

Professor Jeffery: I cannot foresee that far ahead. The example of the Scotland Act 2012 provisions widening the fiscal autonomy of the Scottish Parliament around income tax had an implication for the extent of the block grant. The block grant would be reduced by the value of the 10 per cent reduction in income tax, and it would then be up to the Scottish Parliament to decide the final level. We would imagine that, if there were further adjustments, as has been suggested by the Campbell commission, the devo plus group and the Institute for Public Policy Research in its devo more project and as signalled in the Labour Party commission's interim report, there would be a further consequent adjustment in how the Barnett formula operates. I have seen in none of the discussions so far, although I cannot say that I am privy to the Labour Party commission's or the Conservatives' discussions, a commitment more fundamentally to remove the block element that the Barnett formula describes. Therefore, as far as I can foresee from the available information, the answer appears to be that that is unlikely.

Joan McAlpine: From Professor Armstrong's comments, there seemed to be a suggestion that there would be an adjustment in the Barnett formula and that it would move towards a more needs-based formula. One example that we have is the Holtham commission report, which would result in a £4 billion cut to Scotland's budget. Would that concern you?

Professor Jeffery: The potential to renegotiate funding arrangements will remain if the constitutional relationships within the UK continue to evolve. The Holtham commission produced a set of calculations that would indeed be challenging in the Scottish case if a systematic needs-based approach were applied across the UK. We have not had a systematic needs-based approach in the past, so that would be a significant breach with tradition in a state that tends to follow its traditions and adhere to them quite stickily.

I was not here to hear what Professor Armstrong said, but that is my perspective on those comments.

Joan McAlpine: Thank you very much.

Professor Simpson, you are a former chief economist at Standard Life. Will you reflect on the recent furore over Standard Life in the media? Has what has happened been misreported?

Professor Simpson: There is legitimate concern for life companies and banks that are registered or headquartered in Scotland but most of whose customers are in England. They would want to be reassured that, after independence, people in both jurisdictions would not be disadvantaged with respect to whatever offers their competing companies can make to them. That is one reason why the proposal by Mirrlees and his colleagues is a good one, because it reassures those companies on the score of tax and regulatory questions and it should make it possible for business to be continued as usual.

Leaving that aside and coming to the question of the announcement, I am not suspicious about the substance because, as I said, there are legitimate concerns, but I must confess that I am slightly suspicious about the timing. More important, it seems to me that the uncertainty that is being created can be resolved only by the Government in London, and not by the Government up here. The Scottish Government has put its cards on the table and said, "This is what we propose to do, and if it is accepted, these problems will be resolved." It is up to the Government in London to respond by at least discussing the offer that is on the table. To the extent that it does not discuss it, uncertainty is heightened, and that can only be damaging for financial businesses that are registered in Scotland.

Joan McAlpine: So what you are saying is that it is the political statement by the chancellor that is increasing the uncertainty for businesses.

Professor Simpson: Well, yes. The literature on all of this is fairly boring for anyone who is not an economist—economists tend to like boring stuff—but you will remember that the fiscal commission produced its report about a year ago. It was extremely detailed and went into great depth on all the issues that have subsequently been talked about, yet neither Mark Carney in his speech in Edinburgh six weeks ago nor George Osborne two weeks ago referred to the report of Mirrlees despite the fact that they were addressing exactly the same issues. In the Treasury document that came along with George Osborne's speech, there is a long bibliography that completely omits any mention of Mirrlees' policies. To me, that is a sign that this is a political rather than an economic discussion.

Joan McAlpine: This morning, Crawford Beveridge from the commission revealed to the committee that Her Majesty's Treasury has not entered into any discussions with the commission, despite its best efforts. He contrasted that with the approach of Bank of England officials, who have been willing to engage. That seems to back up what you are saying—that there is a political agenda at work here.

Professor Simpson: I am afraid that that is very obviously the case. Yes.

The Convener: Okay. You have had five questions, Ms McAlpine.

Margaret McDougall: Good afternoon, panel. I have a question about the currency. Professor Simpson, you have said that an informal currency union is an attractive and feasible option because it delivers the main benefits without some of the costs. What are the costs that you believe an informal currency union would avoid?

Professor Simpson: If you enter monetary union with an associated banking union, you have to agree with the other partner limitations on both your activities—budget restrictions, restrictions on regulation and what have you—that might be irksome to you, whereas if you go it alone, as it were, you are free to take your own decisions. Some of them might prove to be imprudent and some of them might be more prudent, but at least you are not trammelled or constrained by external agreements. That is what I had in mind.

Margaret McDougall: What would be the risks associated with that?

12:30

Professor Simpson: Most people would see the risks as the absence of a lender of last resort, but as I said in my submission the historical evidence is that that is an incentive for good behaviour.

I return to Ireland, which is the simplest example. In 1922, Ireland was in very much the same position in many respects as Scotland is now. It left the United Kingdom, continued to use sterling, did not depend on any lender of last resort and yet it had no banking problems when it left that position in 1979. It still had no banking problems until it joined the euro in 2002. That is what I would describe as a classic example of how not having a lender of last resort encourages good behaviour on the part of banks.

The Convener: Professor Bell is shaking his head vigorously at that.

Professor Bell: I do not think that it is true that Ireland had no problems; it had some problems. My classmate Patrick Honohan, who is now head of the Central Bank of Ireland, has written an excellent paper on the history of Irish monetary circumstances.

Professor Simpson: I stand corrected.

Margaret McDougall: I have a question for Professor Bell. If Scotland did not take on its share of the debt and its credit rating plummeted, what would be the effect on the economy in Scotland?

Professor Bell: It is UK debt, not Scottish debt, and the UK has agreed that it will pay back that debt. That is the first thing to say. The question is whether Scotland would offer to service that debt. My understanding is that that kind of offer is on the table, so Scotland would take a population share and make the interest payments on that.

However, what will happen is that each year a certain proportion of that debt will mature. You then have to try to roll it over in the markets if you are to continue to fund your public services. The key question is whether you pay a higher rate of interest, the same rate of interest or a lower rate of interest. Earlier today, there was some debate about what that rate of interest might be. Dr Armstrong has done extensive research on that in relation to the bond deals of different countries in the euro area, which depend on things such as the ratio of debt to GDP.

One thing that would be difficult for Scotland to avoid is liquidity risk associated with bonds. It is really a question of whether, if you are trying to sell, you can find a buyer of Scottish bonds, or, if you are trying to buy, you can find a seller of Scottish bonds. If the market is smaller—undoubtedly it would be—that becomes a little more difficult to do and you build in a premium based on that. In fact, the discussion about differences in interest rates on potential Scottish bonds hinges a lot on that issue.

Margaret McDougall: So interest rates are likely to be higher in Scotland if we were looking to the markets as a new independent country.

Professor Bell: It would depend on other circumstances, but the liquidity risk is unavoidable because Scotland is smaller.

Marco Biagi: Can I just check on that? Liquidity is one of the factors, but other factors would come into it. For example Switzerland, Denmark and Finland—all of comparable size to Scotland—have lower interest rates at the moment on 10-year bonds than the UK does.

Professor Bell: They have much lower debt. Clearly, having low debt is another part of the story. The question that we cannot answer is how the markets would react to Scotland if it decided not to take on a share of the debt and it was felt that it ought to have done so.

Professor Simpson: One of the many factors that enter into this—we have not mentioned it, but the markets would look at it very keenly—is the prudence or otherwise of the budgetary policies of the Government, whether that be the Scottish Government or another. Markets would be much more willing to lend at more favourable rates if they thought that the Government was doing its best to get its finances in order. That is one of the key factors.

Professor Bell: I completely agree with that point.

Chic Brodie: I apologise for quoting again the Standard & Poor's credit rating report, from which I have quoted twice already. It states:

"Scotland would qualify for our highest economic assessment ... Scottish wealth levels are comparable to that of ... Germany".

If Mr Osborne continued with his nonsense and Scotland did not accept any of the debt, Scotland would be in a fairly advantageous place in terms of borrowing.

Professor Simpson: I am not sure whether that was a question.

The Convener: Do you agree or disagree with Mr Brodie's point?

Professor Simpson: To be honest, I am slightly hard of hearing. Would Mr Brodie be kind enough to repeat the question?

Chic Brodie: I quoted from the Standard & Poor's credit rating report, which says:

"Scotland would qualify for our highest economic assessment ... Scottish wealth levels are comparable to that of ... Germany".

As I think that Dr Armstrong said earlier, if an independent Scotland started with no debt, our borrowing capability should be quite reasonable and borrowing would probably be done with lower interest rates than elsewhere.

Professor Simpson: I have read the Standard & Poor's assessment and I have no reason to deviate from it. However, at the risk of being slightly provocative, I would say that if I were in a negotiating position—fortunately, I will not be—I would be disinclined to automatically take on any share of the UK debt unless there was some quid pro quo from the other side. To return to the example of Ireland, when it left the UK in 1922 it did not take on any of the UK's national debt. That was in exchange for—I think—moving the border further away from Belfast.

If I were a negotiator for Scotland in the circumstances concerned, I would say that we would not be prepared to take on any share of UK national debt but that we would give up our claims to Berwick and Carlisle.

Chic Brodie: That is interesting.

The Convener: Does anybody else want to comment?

Professor Bell: David Simpson has hit on an important point, which is that it is pretty difficult to predict exactly where we might or might not be, because there would be so many things in the mix with regard to a negotiation. It is very difficult to know where it would go. We can point to factors that might influence a negotiation—for example, the interest rate that might pertain to Scottish debt—but we do not really know.

Alison Johnstone: Professor Bell was previously involved in a study that looked at inequality in Scotland. What tools do you believe we currently have at our disposal to most effectively address that inequality? What tools might we have in an independent Scotland to do that? What do you regard as the optimal scenario for addressing the inequality that we face?

Professor Bell: Our paper argued that, although one can fiddle about with the tax and benefits system to some extent, inequality in Scotland and the UK is such that movements in tax and benefits are unlikely to bring down inequality levels substantially and might have negative incentive effects on employees and employers. An independent Scotland would have to think carefully about the missing middle—the gap that has opened between the relatively poorly paid workers who are involved in personalised services that cannot be substituted by Chinese labour and the very skilled people who innovate, who work in science parks, the financial sector and the oil sector and who drive the Scottish economy forward. The gap between those groups has grown and there is no obvious ladder from one to the other in the way that there used to be from being an apprentice to being semi-skilled, skilled and a foreman and then going up into management.

A lot of what the Scottish Government would have to think about is how to have more people who have a middling level of pay. The living wage could be looked at as part of that, but even that is a relatively low wage. The Government would have to work with industry to raise the skills, competences and employability of young people to the levels at which more skilled jobs could form a bigger part of the economy than they do now.

Alison Johnstone: I appreciate that you say that the tax system is not the answer to all the issues, but I will go back to it. How quickly could we make a transition to an independent tax system? Are we looking at 10 years? What would the transition look like?

Professor Bell: Bits of the system are already in place. The Scottish rate of income tax will be administered by HMRC so, in that sense, it is not Scottish. However, revenue Scotland will operate the stamp duty land tax replacement and the landfill tax, so a Scottish body is in existence.

With good will, it would be possible to transfer quite a lot of the personal tax stuff relatively quickly, but corporate taxation would be much more complex. A big issue would be how contracts between oil companies and HMRC were transferred into contracts between oil companies

and the Scottish Government. That could not be done overnight. Movement on personal tax could be reasonably swift, but processes of negotiation would be required to set up other components of the tax system, because some players on the other side of the fence are pretty big.

Alison Johnstone: You said that tax is not the answer and that we need to ensure that our young people are properly skilled. Could we do more under devolution? What do you suggest as a first step?

Professor Bell: There is a case for looking at the balance of spending in education. I might be about to say something that is quite unpopular. We could compare how much is spent on higher education, for example, with what is spent on the early years, which all the evidence says are critical to young people.

Another issue is the interaction between services that the Scottish Government provides and services that are provided through the welfare system broadly defined, such as jobseekers allowance. I am not an expert in that area, but it is not obvious to me that the provision is joined up, coming as it does at present from two different sources of authority.

12:45

The Convener: There are still four members who want to ask questions, and we are a little short of time, so it would be helpful if questions and answers could be sharpened up a bit.

Christian Allard: I have a question for Professor Jeffery on his earlier comments about negotiation between politicians and others.

You highlighted Mark Carney‘s statement that the Bank of England would implement a currency area if that is what politicians agree. I know that you said that you were not surprised by the chancellor's reaction and that that is the way in which negotiations would take place given the difference between the Scottish agenda and the RUK agenda, but Mark Carney, as a Canadian, seems to have a different view of how things will pan out after a yes vote. Could that political stance survive?

Professor Jeffery: I am not sure that Governor Carney has overt views on the outcome of the referendum and what will follow. I think that he was saying that, if there were a yes vote and the two Governments agreed on a currency union, it would be his job to implement that, to ensure that the correct governance arrangements were in place and no doubt to advise on ancillary matters such as the level of fiscal co-ordination that might be needed. He was careful to place himself in a technocratic position and to say that he will do what the political bosses agree should be done. I do not think that he was making a statement on the negotiation process following a yes vote.

Christian Allard: But he came up to Scotland and made a speech to the Scottish Government in which he said things that the politicians are not saying.

Professor Jeffery: I do not know what he might have said to the Scottish Government while he was here.

Christian Allard: There seems to be a political stance that does not reflect the reality that we hear when we talk to the governor of the Bank of England, who does not need to take a political stance and who is more interested in solving issues rather than creating conflict.

Professor Jeffery: The governor's point, which was made less in his speech and more in the discussion afterwards, was that if politics were to come to that conclusion he would fix it.

Richard Baker: My question is on the same issue. Is the stance that the chancellor, the UK Treasury and others have taken really that unreasonable, given our experience of recent history?

In the previous session we talked about the sharing of risk. We had a situation in which there was a financial crash, and two of the major banks of Britain, which were headquartered in Scotland, had to be bailed out to the tune of around £47 billion, including the underwriting of toxic debt. Our First Minister at the time advocated a light-touch approach to financial regulation, on which there was unfortunately a consensus.

Given that experience, is it really unreasonable for UK ministers and the Treasury to be sceptical at the very least about that proposition?

Professor Jeffery: I will offer one or two thoughts on that, although I do not particularly want to get into using language such as reasonable and unreasonable.

There are a number of features of the UK Government's position. One feature is to state clearly that, in the event of independence, the UK Government will be responsible for the territory of the current UK minus Scotland and will calculate a national interest on that basis, which may interact with the issues that Richard Baker has just raised. We are now in a different era in terms of understanding how to undertake financial regulation from where we were back then.

The UK political system more generally—Westminster and Whitehall, to give the shorthand—has a different understanding of independent statehood, which it is projecting on to a possible future relationship with Scotland. There

is a different mindset from that which the Scottish Government represents, and there may well also be a shorter-term tactical element in the way in which the chancellor and the others have presented their case in order to help to win the referendum from their perspective.

Richard Baker: The point that I am making is that the debate is not just about politics—there is a strong economic argument that a small partner in a monetary union can cause a huge burden in terms of risk sharing. I do not know whether any other member of the panel has a similar view.

Professor Jeffery: That is clearly one of the issues that would be part of the national interest calculation. I observed in my submission that the eurozone faces enormous tensions in respect of the fundamentals of its different members, which are in a far greater state of divergence than the fundamentals of RUK and Scotland would be, and yet there is the political will—among the strongest and the weakest—for the zone to persist.

That suggests that politics, and not economics, can be one of the fundamentals in the debate. I offer that observation simply to give a broadly comparable example of how politics and economics exist in a dynamic relationship with one another, and to show that politics often predominates.

Richard Baker: With regard to Professor Jeffrey's example, I am not sure that the eurozone is a cracking success.

My final question is for Professor Simpson, who has previously advocated that, if Scotland were to be independent, that would help it to address a culture of dependency and to create a more business-friendly environment. Why could those things not be established under a greater devolved settlement, through devolution plus, which Professor Jeffrey mentioned earlier, or even through devo max—whatever you want to call it?

Professor Simpson: The question is one of restoring confidence, and if a devo max settlement were to achieve a cultural change, that would be nine 10ths of the result. I do not know whether that will happen, but I would not rule it out.

On Richard Baker's last question, it might seem quite reasonable for someone who is representing the Treasury to say, "Look, we don't want to take on the risk on behalf of English taxpayers that there will be another Royal Bank of Scotland-type collapse with an unknown quality of liabilities." As I indicated before, that would be most unlikely to happen, but in any case the elements of any monetary union that was agreed between an independent Scotland and England would have to include a clear understanding of what would happen in the event that some part of the burden of a future insolvent bank in either part of the territory should require an element of taxpayer support. There would have to be a clear agreement in advance on how that support would be parcelled out.

Marco Biagi: Membership of the EU is very important to business in Scotland. Professor Jeffery states in his submission that, in the event of a yes vote,

"The conclusion of almost all independent expert analysis is that Scottish EU membership would be uninterrupted".

In the event of a no vote, how much pressure do you think that the UK Government would come under to hold a referendum on EU membership, and what would be the likeliest outcome of such a referendum?

Professor Jeffery: I think that there will be very strong pressure from precisely the direction that you indicate, with businesses expressing concerns about EU membership in the Scottish case and in the UK case. I suspect that businesses with an international operation are likely to be rather worried about the prospect of the UK leaving the EU.

On the question of how a vote might turn out, colleagues at Cardiff University and I have done a number of public attitude surveys in England that explore, among other things, the EU question. Those surveys reveal a significant distinction when we compare public opinion in England with public opinion in Scotland and, to a lesser extent, when we compare it with Wales. There is a much stronger sense that the EU is a governance problem in England than there is in Scotland and Wales. There is a stronger antipathy towards the EU in England than there is in Scotland in particular and in Wales to an extent.

That is not to say that the Scots are wildly enthusiastic about Europe. They are less sceptical and probably a bit more pragmatic. There is something a little more elemental in the English attitude. In our last survey, we asked the referendum question, "In or out of the EU?" We would not face that situation were Mr Cameron to win again and then renegotiate and put together a renegotiated package—we do not know what that package would be. However, the clear pattern of opinion in that last survey, which was conducted in November 2012, was for the English to vote against remaining in at the same time as contemporary polls were saying that there was a Scottish majority in favour of remaining in and a lesser majority—but still a majority—in Wales in favour of remaining in. There are differences in public attitudes on the European question that have a territorial element in the UK.

Marco Biagi: What would be the economic consequences for Scotland in the event of a so-called Brexit?

Professor Bell: I was just thinking about Professor Jeffery's answer and if you substituted the word "migration" for "EU", you would have exactly the same set of answers. Work that we have done at the ESRC centre in Oxford shows that attitudes towards migration are more negative in England than they are in Scotland. That is not to say that Scottish people are all in favour of migration; attitudes are still a bit negative in Scotland.

Of course, migration is one of the key economic drivers that would influence Scotland's economic development. Scotland's level of income is relatively high within the UK, yet the proportion of its citizens who are foreign born is much lower than we would expect. The welcome increase in the population that has occurred in the past decade or so has pretty much been driven by inward migration.

I wonder what I should say given the stories that are going around today about reports on migration. I suspect that, if the analysis had been done in Scotland, it would have shown that migration had had a very positive effect on the population and on the economy.

Marco Biagi: And what would be the effect of a Brexit—to use that horrible word again?

Professor Bell: It would certainly complicate the migration issue. It is possible—Quebec is an example of this—for a part of a state to have its own differentiated migration policy but it is trickier than if it was a separate state.

Mike MacKenzie: I will follow up on that theme with Professor Bell—on the challenge that faces us in the demographic future of Scotland. I am sure that you would agree that Scotland does not have many of the tools that can be used to tackle that challenge and boost the working-age population. Do you foresee a future in which Scotland is unable to respond to that demographic challenge and in which things therefore get quite serious?

13:00

Professor Bell: The answer to that is a bit like the answer to the previous question. Scotland has a demographic challenge in that, by 2030, the ratio of people who are of working age—however that is defined by that time—to those over that age will be much lower than it is now, and slightly below that in the rest of the UK. However, that is relative, in the sense that the demographic challenge in Scotland and the UK will be less extreme than in most of Europe. The OECD thinks that, within Europe, the UK has the best long-term growth prospects, and the reason for that is that it faces the least extreme demographic challenge, although it is still a challenge. Germany and Italy will face the strongest such challenge.

Basically, we will be in a situation in which there are not enough births and countries will be trying to attract young people. Therefore, Scotland will need to have an attractive economy, because young people move to where economies are most vibrant. To me, that seems to be a precondition to adjusting in a better way to the demographic challenge that Scotland certainly faces.

Mike MacKenzie: My next question is for Professor Simpson and is on a different subject. Does Standard Life's recent announcement strengthen rather than weaken the case for a currency union?

Professor Simpson: It very much strengthens the case for a monetary union because, as I said, monetary union with the associated banking union should provide a uniformity of conditions on both sides of the border for banks and insurance companies. That is one reason why I am in favour of it.

Mike MacKenzie: My final question is on an interesting area that you touched on in your written evidence. You seem to suggest that the risks that are associated with Scotland's financial sector have been dealt with already through banking regulation, in that those risks are now correctly assigned to shareholders and creditors rather than taxpayers at large. Is my understanding correct?

Professor Simpson: I am not familiar with the detail, but I know that a couple of pieces of UK banking reform legislation that were introduced in 2010 and 2013 have brought in the principle that, when a bank is in danger of becoming insolvent, the procedure is for the initial liabilities to fall on the shareholders, creditors and managers rather than on taxpayers.

I do not know the extent to which there is a taxpayer back-up, and maybe the legislation does not specify that. However, in principle, there is no reason why one should not remove the taxpayer entirely from the equation. The banks would all be in the same position. If a big bank got into trouble, there would be a well-established procedure for orderly liquidation, and the burden of the cost would fall on those three categories of management, shareholders and creditors, while the depositors would of course be protected by a guarantee scheme, as they are now.

That should be the model to which we are all moving. The European Union and the Americans seem to be moving in the same direction.

The Convener: If no one has anything to add, we will call it a day. We are slightly behind the clock, but we have done well. I thank the

witnesses for their contributions and members for their co-operation.

13:04

Meeting continued in private until 13:07.

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