The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

FINANCE COMMITTEE

Wednesday 30 April 2014

Session 4

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FINANCE COMMITTEE
13th Meeting 2014, Session 4

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*John Mason (Glasgow Shettleston) (SNP)

COMMITTEE MEMBERS

*Gavin Brown (Lothian) (Con)
*Malcolm Chisholm (Edinburgh Northern and Leith) (Lab)
*Jamie Hepburn (Cumbernauld and Kilsyth) (SNP)
Michael McMahon (Uddingston and Bellshill) (Lab)
*Jean Urquhart (Highlands and Islands) (Ind)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Dr Angus Armstrong (National Institute of Economic and Social Research)
Jo Armstrong (Centre for Public Policy for Regions)
Jim Cuthbert
Margaret Cuthbert
Iain Gray (East Lothian) (Lab) (Committee Substitute)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance Committee

Wednesday 30 April 2014

[The Convener *opened the meeting at 09:31*]

Decision on Taking Business in Private

The Convener (Kenneth Gibson): Good morning and welcome to the 13th meeting in 2014 of the Finance Committee of the Scottish Parliament. I remind everyone present to turn off mobile phones, tablets or other electronic devices. We have received apologies from Michael McMahon. Michael's substitute today is Iain Gray. Do you have any interests to declare, Iain?

Iain Gray (East Lothian) (Lab): I have nothing to declare.

The Convener: The first item of business this morning is to decide whether to take item 3 in private. Do members agree?

Members *indicated agreement.*

Scotland's Public Finances Post-2014

09:31

The Convener: Our second item of business is evidence on Scotland's public finances post-2014. I welcome to the meeting Dr Angus Armstrong of the National Institute of Economic and Social Research, Professor Jo Armstrong of the Centre for Public Policy for Regions, and Jim and Margaret Cuthbert. Committee members have copies of written evidence that has been submitted by the witnesses, so we will go straight to questions. As is normally the case at the Finance Committee—as I am sure you all know because you have all been here before—I will start off with some questions then open out the session to colleagues around the table.

So, where do we start? First, we have had really interesting and impressive submissions from all of you. Your submissions are incredibly diverse. In reading them, I sometimes wondered whether we were all talking about the same subject because the conclusions that have been drawn are so diverse.

For no particular reason, I will start with Jo Armstrong. If other witnesses wish to comment on what Jo has said, please indicate that to me and I will be happy to let you in. When I ask other members of the panel questions, the same will apply.

In your fascinating submission, Jo, you say that

"in 2012-13 Scotland's share of the UK's debt interest and loan payments associated with such historic debt was estimated to be £4 billion ... This is expected to rise to over £6 billion by 2018-19."

You have argued in your paper

"for Scotland assuming a low, or zero, share of the UK's existing debt".

The Scottish Government has indicated its willingness to accept its share of the debt. Will you talk us through the logic to your paper and why you have come to the conclusions in it?

Jo Armstrong (Centre for Public Policy for Regions): The Scottish Government has indicated that willingness; my paper is not an attempt to say that it is wrong, but an attempt to say that beyond a yes vote there will be a host of negotiations. One might be around Scotland's share of debt. Scotland would not necessarily be walking away from debt, but this would be about an agreed negotiated position, receiving a zero-debt opening position.

The reason for that was that the finances that Scotland would face beyond the referendum, at least in the short term, do not look terribly positive because of its onshore fiscal position being in deficit. That deficit would not be eliminated through the amounts that are projected for North Sea tax revenues in official statistics. Therefore, starting with a zero-debt position and not having to take on debt interest costs would produce a surplus for Scotland. We thought that the point was at least worthy of putting out there, as part of the debate about what a negotiated settlement might look like—[*Interruption*.]

The Convener: We have a problem with the microphones, which I am told will take 30 seconds to sort out.

09:35

Meeting suspended.

09:35

On resuming—

The Convener: At least it was only 30 seconds.

Do Professor Armstrong or Jim or Margaret Cuthbert want to comment on what Jo Armstrong said in her paper?

Jim Cuthbert: You will have seen that in our submission we, too, covered the question of Scotland's initial debt. We take a different line.

A Scottish negotiator might start by looking at what Scotland's oil fund might have been, had Scotland been independent since 1980, and such a negotiator's starting position might be to look for some recompense for the £150 billion oil fund that Scotland might have been enjoying.

Even before one gets to that, there is a question about the size of the current debt interest payment, which brings us to the thorny issue of quantitative easing. Actually, a third of UK debt has been quantitatively eased, and the interest on that recycles straight back to the Treasury—

The Convener: I realise that you have talked about that in your submission and I am happy to discuss the issue, but so that we do not wander all over the place, will you give your view on Jo Armstrong's position? I will bring in the other panellists to comment on what you say. Members of the committee have many questions to ask, so I do not want to drift on to quantitative easing at this point.

Jim Cuthbert: It is relevant, because if we are looking at the starting fiscal position, the common approach is to project forward from the "Government Expenditure and Revenue Scotland" deficit. That is what Jo Armstrong has done, in effect. However, I suggest that because of quantitative easing the GERS deficit is overstated by something like 0.8 per cent of gross domestic product.

Another relevant point when we consider the size of the current GERS deficit, is that it implicitly assumes, for example, that Scotland is spending 2.2 per cent of GDP on defence and 0.5 per cent of GDP on international services. An independent Scotland would potentially take a different view on those areas. Ireland spends 0.6 per cent of GDP on defence, New Zealand spends 1.1 per cent and Denmark spends 1.4 per cent. When we add all those things up, we see that the current GERS deficit potentially overstates the position of an independent Scotland by something like 2.3 per cent of GDP. That is relevant to the starting position in Jo Armstrong's argument.

Margaret Cuthbert: My point is also about the baseline that Jo Armstrong used. As she said, the onshore fiscal deficit currently looks poor, and that formed the basis of her looking at whether we would take on debt. I thoroughly agree with her that we must consider not taking on debt, but I also think that the onshore fiscal deficit is exaggerated for the future. The UK is particularly poor at collecting tax—especially corporation tax. In addition, UK taxes are not necessarily in sync with what we should be collecting in Scotland. If we took a different approach, our onshore fiscal position could be considerably improved. I can go into that in more detail.

Dr Angus Armstrong (National Institute of Economic and Social Research): I was surprised to see the CPPR's research bringing up a hypothetical example—I think that the point was to try to illustrate an argument, but Jo Armstrong can explain the motivation for doing that. Most people on all sides, and all economists, think that a fair and equitable share of the debt is probably the right way to proceed. I think that most people find the idea of zero debt and meeting criteria in that regard challenging.

There are broader issues. It is extremely hard to see how zero debt would be agreed and it is not that easy to walk away from debt. There are still a lot of claims being made against countries that walked away from their debt 20 years ago. The debt stays, and both sides have to decide on what is appropriate.

There is the much larger context of Europe; there is a lot of discussion about debts in Europe. To walk away from that would be an extraordinary precedent to set. I can understand that it has been put out there as a hypothetical case, but I do not agree that it is a reasonable proposition.

The Convener: Okay. I am going to turn to—

Jo Armstrong: Could I respond to that please?

The Convener: Of course.

Jo Armstrong: The proposition is hypothetical, but it is within the context of all things being on the table during a negotiation. Zero debt would fundamentally change Scotland's fiscal outlook in the short term.

Although there will be opportunities to change tax rates, bases and types, the current trend is all that we can work on at the moment. The short-term trend out to 2018-19 is that Scotland will have an onshore fiscal deficit that is quite large and will not be eliminated by North Sea tax revenues. Although all bets are off in the longer term, and opportunities might exist, the short-term trend—what is in the pipeline and what we know now, irrespective of the vote in September—is that Scotland would have to deal with a higher fiscal deficit than the UK.

The Convener: Dr Armstrong—I turn to your submission. Under the section that is headed "Borrowing" there are some fairly alarming figures, which I found difficult to comprehend. You talk about a potential "clean break" option, with the Scottish Government paying the UK Government an astronomical £102 billion in cash in 2016-17. The other option that you give is an IOU, whereby Scotland would pay its share. Under the IOU option, you say that Scotland

"would issue only a share of the maturing debt, plus the interest on the IOU."

I am not sure why we would pay that in parallel. You say that

"This implies a first year payment to the rest of the UK of around £23bn (repayment plus the IOU ...)".

That seems to me to be an extraordinarily large sum of money. Would the maturing debt not, in effect, be reissued? Do you seriously think that the UK is going to pay off £224 billion in that year and that we will have to stump up £23 billion of that? How is that realistic or possible in any way at all?

Dr Angus Armstrong: You are quite right to say that they are very big numbers. Government debt means extremely big numbers. Although they are eye-wateringly big, they are 8.4 per cent of an agreed amount of debt. You have to have an agreed amount of debt first. We can argue about what is the right number, but we have taken £140 billion-odd as the Maastricht measure or the gross debt. It is based on the population and it is an equitable share. It has been used in the white paper and various other places, and it awards Scotland its geographical share of oil. That is how we got to the £140 billion.

After independence, that £140 billion will be an independent Scotland's share of the existing UK debt. That would in fact be Scotland's debt to the Government of the rest of the UK, because the UK has accepted on-going liability for the debt that has been issued.

The question is this: how is that debt to be repaid? To repay it, Scotland has either to hand over a reduced sum of its assets, or it has to raise its own debt to repay its debt to the rest of the UK. That is the IOU option.

Why does the £140 billion go down to £100 billion? That is because the £140 billion is spread over a number of years according to the yield curve—the date at which bonds have been issued. There is a big difference between owing £140 billion in eight years and having to pay £140 billion today. The discount factor reduces that figure down to about £100 billion in cash terms today.

09:45

One option is to pay that in cash terms or reduce your assets in cash terms. The other option is to pay it over time. That means 8.4 per cent of each of the bonds maturing over the yield curve. We know that approximately £225 billion of Government debt matures in the first year, according to the existing yield curve. The 8.5 per cent of that covers only about £18 billion of the £140 billion, so the other £122 billion is outstanding. That is what the interest is being paid on—the rest, which is not being paid off. The 8.5 per cent of the maturing one-year debt is approximately £18 billion. That money has to be repaid in the first year. The rest of the loan or IOU would still be accumulating interest, and would still be owed. You have £140 billion minus the £18 billion—£122 billion—and that is what the interest would be paid on. If we take the UK Government bond rate, that comes to about £3.5 billion. So, there is the £18 billion, plus the £3.5 billion, plus whatever fiscal deficit there will be. I am not reading out the figures, so forgive me if I am rounding the numbers. That is how we reach what are, indeed, very large numbers.

The Convener: You are saying that the UK is going to pay £224 billion off if Scotland is not independent that year.

Dr Angus Armstrong: No. As regards the £224 billion in the first year, the bondholders will be repaid—absolutely and unequivocally. Yes—they will be repaid, but the question is this: how will they be repaid? The UK Government will issue bonds to repay them, just as the Scottish Government would issue bonds to repay its share of that £224 billion.

The Convener: Exactly. So, how do we end up having to cough up £23 billion in a year, if we are issuing bonds in the same way as the UK Government?

Dr Angus Armstrong: They are the bonds that you would have to issue.

The Convener: In her paper, Jo Armstrong said:

> "Scotland's share of the UK's debt interest and loan payments associated with ... historic debt was estimated to be £4 billion ... expected to rise to over £6 billion".

Surely that would be a more realistic figure once the shenanigans had taken place.

Dr Angus Armstrong: The big difference is repayment of the existing principal. If I have a mortgage, I can have an interest-only mortgage, or I can pay off the mortgage—the principal. In these calculations, we are assuming that the principal is going to be paid off in line with the existing maturity of UK debt. For the UK Government, of that existing maturity, £225 billion matures in one year, and 8.5 per cent of that is about £19 billion. That is the share of the principal that you would be repaying.

The Convener: Yes—you have said all that. Surely the net amount that we would actually pay after the reissuing of bonds and so on would mean that we would not have to be faced with paying £23 billion.

Dr Angus Armstrong: We are talking about the amount of bonds that an independent Scotland would have to issue in order to meet its obligations. It would have to issue bonds to cover the 8.5 per cent of the £225 billion, which is about £19 billion. It would have to issue bonds to cover its interest obligations on the rest of it—the non-outstanding debt—plus the deficit. Those numbers are £25 billion or £23 billion, as is quoted in the papers. There was no deficit there. I do not know what the deficit is going to be in 2015-16, but it would be a brave man who would assume that it would be zero.

The Convener: I did not see any reference to bonds and so on. Your submission says:

> "Under either repayment option an independent Scotland would have a high debt burden (although lower than the rest of the UK)."

Dr Angus Armstrong: Yes. That is true. That refers to the rest of the UK's debt burden. For clarity, debt burden is the ratio of debt to gross domestic product or gross national income, if there is a difference between gross national product and GNI. That is the amount of debt divided by the resources of the domestic economy. The debt burden of the rest of the UK, if there is Scottish independence, will rise by about 10 percentage points. That is quite a big difference for the rest of the UK—it is quite a big impact. The statement that Scotland's debt burden would be below that of the rest of the UK is true.

What is "high"? "High" is a fairly relative term, but most people would consider a level around 80 per cent to be high. There are a lot of countries that currently have high debt burdens but, compared with comparable countries, a debt ratio of 80 per cent would be perceived as high. It is not necessarily punishingly high, but it is certainly high. It is, however, significantly lower than the debt ratio of the rest of the United Kingdom.

Jim Cuthbert: Dr Armstrong mentioned the negotiating position on debt in the white paper. I recall that the white paper contains two positions—one is that the Scottish Government might take over a population share and the other is that it might take a share that is based on a calculation of the historical deficit. I hold no brief for either of those figures. In the paper that we did on debt, we took issue with both positions, so I do not seek to defend them.

If one could put oneself in the mind of the white paper's drafters, one might imagine that they were operating under the terms of the Edinburgh accord, which were in effect that the whole business would be conducted in a gentlemanly fashion and the gloves would not come off. Unfortunately, the gloves have come off, because of the negotiating position that the unionist side has adopted on the currency, for example.

The positions on debt in the white paper are flawed and untenable. The issue should be approached in line with the principles that are set out in the Vienna convention, which fundamentally concern equity. Despite what Dr Armstrong said, the judgments will not be made by economists; they will be political judgments that depend on relative bargaining positions and on the public's perception of what is equitable. Under the principle of equity, negotiators would have a strong case for arguing that Scotland should start by making a claim for compensation of about £150 billion. The negotiations should move on from there. In the light of that, the idea of a zero-debt position for a newly independent Scotland is not at all unfeasible.

The Convener: I will ask a wee bit about that in a moment. What is Jo Armstrong's comment on the figures that Dr Armstrong has used in the NIESR submission?

Jo Armstrong: Given the current fiscal outlook, if Scotland takes on its share—whatever the figure is—it will have to raise debt in order to pay back its obligations. The net net position might be that we end up paying roughly the same interest rate, although even that is questionable, but Scotland will have to raise debt and pay back on the basis of the current UK Government's obligations to pay back to the money markets.

If that format was not followed, Scotland would start to have problems with raising its own debt in the money markets. Although people do not like the big numbers, that is the reality of taking on such a share of debt. If the share of debt was smaller, Scotland would have to raise less debt. However, taking on a share of debt, in a world in which we have a fiscal deficit, means that Scotland would have to raise debt of its own, and the numbers are large.

Dr Angus Armstrong: Can I come in, convener?

The Convener: Of course, Professor Armstrong—I mean Dr Armstrong. We have a plethora of Armstrongs.

Dr Angus Armstrong: That is quite all right.

There are other options. We have stressed the option that debt can be reduced by transferring assets. When we have such a large and volatile asset, it might make good economic sense for both sides to make a transfer, as politically difficult as it might be. The numbers are big—on the basis of equity, which Jim Cuthbert mentioned—but perhaps we should look at the other options, which do not seem to get such an airing.

The Convener: I am interested that you say:

> "We propose a debt-for-oil swap which would leave both sovereign nations better-off: the idea actually offers a real 'free-lunch'."

There are other assets, such as the UK's defence assets, which are worth about £92 billion. Scotland's share of them would be about £7.75 billion, but only about a fifth of those assets are in Scotland. Would you advocate offsetting some of them against Scotland's debt?

Dr Angus Armstrong: Yes. All the assets must be taken case by case. Some assets are fixed to their location—for example, a motorway could not be moved. However, some warheads or ships could be moved and traded separately. Oil is sold on to world markets, which is why it is a useful asset; it is not specific to a location, whereas assets such as motorways depend on their location. Each asset would have to go through negotiation. It is perfectly reasonable that some of the military assets that are mobile and not specific to a location would be part of that.

The Convener: You teased us a wee bit in your submission by mentioning a debt-for-oil swap without going into it in any great detail. How would that work?

Dr Angus Armstrong: It was part of a paper that we put out last September or October—I am not sure which month it was. The idea is that, for countries that have a smaller set of assets, having an asset that is highly volatile can be problematic to manage. For bigger countries—those that are 11 times bigger or thereabouts—having that volatility is easier to manage. That is just in the nature of a bigger nation; it does not say anything about debt ratios and everything else.

If both sides could agree on a fair value—the tax value or even the expected value—for what the oil reserves are worth, where would the volatility be most easily managed: in the smaller country or the bigger country? The answer is, of course, in the bigger country, if one assumes that a fair conclusion on worth can be reached. Transferring some of the volatility to the bigger country would mean that the smaller country would benefit because it would not have the difficulty of dealing with the asset. The bigger country, which would not have that much difficulty in dealing with the volatility, would presumably be willing to pay a slightly higher price. The price in the middle would be the free lunch, because the countries would be doing something that is better suited to being organised in that way.

That presumes—I accept that this is the major presumption—that the countries can agree on what the stuff is worth.

The Convener: I will let colleagues in soon, as they have been quite patient. I will let John Mason in first with a brief supplementary, and then Margaret Cuthbert, and I will ask one final question before committee members come in.

John Mason (Glasgow Shettleston) (SNP): I just wanted to ask a question on that point.

The smaller country would lose the volatility, but it would also lose any potential upside. If the price went up over time, it would have lost that bonus.

Dr Angus Armstrong: That is 100 per cent correct: it would lose the upside and the downside. It would get cash today depending on what it believes to be the discounted value of the tax revenues; that would presumably count against the debt immediately. In one step, the debt profile of an independent Scotland would look completely different. We would then be dealing with a different proposition.

Margaret Cuthbert: I wanted to comment on that exact point. We would lose the upside. In fact, looking at the Office for Budget Responsibility's figures on oil and Alex Kemp's figures, and at the figures from the Scottish Government, which it has based on Alex Kemp's figures, there is a huge difference in the return that is expected from oil in the period up to 2040. We are starting very much from different ends of the negotiating table with regard to what the value of oil is. To my mind, what Angus Armstrong suggests is just an oil grab on its way through.

I have two other points to make. On assets and liabilities, I agree entirely that, as with the Vienna convention, we would have to bring in what assets Scotland would like to take. In that regard, we would be unlikely to take in anything like our population share of UK debt. If, at that point, we were to say, "Well, there is a huge bit of debt that neither side wants," I would suggest that that is due to the mismanagement of the UK economy over the past 40 years.

Oil is a very poor asset to take, because of its volatility. I agree that it would be much more sensible to take defence assets and the high-speed train line.

The Convener: My final question before I open up the session to colleagues is on an issue that Jim Cuthbert raised. Your submission suggests

"debt sharing ... using the principles set down in the UN's Vienna Convention of 1983"

but notes that

"the Convention was never ratified".

When the Soviet Union broke up, none of the 14 new independent states, other than Russia, took any of the debt—it all went to Russia. Some of those countries, in particular some of the Baltic states, were in effect ransacked by the Soviet Union in the decades prior to their becoming independent, and yet no compensation was paid. You suggest basing the negotiation on the principle of equity and, as you have already mentioned today, state that

"If Scotland had become independent in 1980"

it would perhaps

"have an oil fund of around £150 billion",

and that the UK should compensate Scotland for that. Surely there is no realistic possibility whatsoever that the UK would agree to the latter suggestion or to anything like it.

10:00

Jim Cuthbert: We are talking about a starting point in a negotiation, and about our position in the court of world opinion, which is very important. There is a common view that, if Scotland did not take on a share of UK debt, it would be regarded as defaulting. That is a judgment for the court of world opinion to make. If Scotland refuses to take on debt because it has effectively been plundered of £150 billion, that does not amount to a default. In the bond markets, a debt-free country with strong natural resources is potentially likely to be a better credit risk than the rest of the UK, which is in a very dodgy budgetary position.

The Convener: Jo Armstrong has asked why, if that is the case, we would start at 1980.

Jim Cuthbert: We discussed that in a paper that we published for the Jimmy Reid Foundation; it is listed at the back of our submission. We discussed why one might take 1980 as being a starting point, and we gave some reasons in that paper that explain why it is definitely reasonable to start there. Another reason, which we did not give in that paper, is the 1979 referendum. A Scottish negotiator could well make the point that, in 1979, Westminster ignored a majority vote in Scotland for fundamental constitutional change, and so from that point, essentially, all bets were off with regard to the division of subsequent assets.

The Convener: Thank you.

Dr Angus Armstrong: On the point about world opinion and the convention, we are not talking about the Congress of Vienna in 1840. Vienna passes a lot of conventions. With regard to world opinion, I suggest that you look at the countries that have ratified the convention—that is hardly world opinion.

Jim Cuthbert: No, no—I am not talking about world opinion with regard to any convention. I am talking about the world and market view of a potentially debt-free independent Scotland and of the reasons why it was debt free and why it would be reasonable for Scotland to refuse to take on a part of the UK's debt.

Dr Angus Armstrong: Far be it from me to bring up the names of people who have got things so badly wrong, such as rating agencies, but S&P says that its guesstimate, which I think is based on 2013 figures, or maybe 2012 figures; I am not quite sure—

The Convener: Standard & Poor's?

Dr Angus Armstrong: Yes. Its estimate of the debt-to-GDP ratio for an independent Scotland—a hypothetical number, obviously—is 77 per cent.

There are a lot of hypotheticals—in fact, there is an infinite number—but, with regard to world opinion, the convention is more notable for the lack of any ratifying Organisation for Economic Co-operation and Development countries.

At least one ratings agency—I have not seen figures from the others; I am not sure that they have yet specified what they think the parameters for an independent Scotland would look like—has said what the debt share would be. We know that in Czechoslovakia and, as the convener pointed out, in many of the former Soviet Union states, there was not much debt—it was very problematic.

We know from the experience of Quebec, despite the fact that it did not ultimately split from Canada, what measures were being negotiated as reasonable parameters. There were about four of them.

Affordability is the other way of approaching the issue—it sounds quite like equity. Affordability would leave an independent Scotland, once we take into account the oil share of GDP—

The Convener: Paying a higher share.

Dr Angus Armstrong: Paying a higher share. I am not advocating one versus another; I am just saying that, if we look at what Canada was considering as reasonable options, affordability and population were the two central cases, apart from what were clearly the interests of people who were arguing on one side of the debate or the other.

The Convener: Does Jo Armstrong have any comments to make?

Dr Angus Armstrong: That just flags up the fact that, beyond a yes vote, the negotiation parameters are wide and the outcomes are uncertain, and we still have to fund current spending plans.

The Convener: I will let Margaret Cuthbert make the last point on that question, because she has not commented on it yet.

Margaret Cuthbert: What Angus Armstrong has said shows that there is everything to play for. There are no proper examples from the past, so it is really a political game on that issue.

The suggestion that Scotland could end up paying more if we approached the issue on the basis of affordability shows that, as Jim Cuthbert said, we are in a good position after independence, as far as world markets go, because they would indeed regard us as being capable of paying and as being a worthy debtor.

The Convener: Thank you. That has been a fascinating opening round. Committee members have been very patient, and I will now open the session to them. The first person to ask questions will be Malcolm Chisholm, to be followed by Jamie Hepburn.

Malcolm Chisholm (Edinburgh Northern and Leith) (Lab): Along with the 1980 question, the other factor that Jim and Margaret Cuthbert are not taking into account is the relatively high levels of public expenditure in Scotland compared with the rest of the UK, which is, obviously, the point that the rest of the UK would make in response to the proposal.

I know that the Scottish Government is not supporting your position. As far as I understand it, it is supporting the position that was helpfully explained by Dr Armstrong in relation to debt and bond markets. My first question is a follow-up to that point. After his explanation of the situation that would pertain in terms of new borrowing, Dr Armstrong says:

> "Our analysis shows that an independent Scottish government would be likely to pay between 0.72% and 1.65% higher interest rates for borrowing at ten year maturity."

I think that the question of what the interest rates would be in an independent Scotland is clearly important, as well as being pretty controversial.

I would like to know whether Dr Armstrong was assuming some currency arrangement when he came up with those figures. In another paper of his that I read recently, he made a comment about dollarisation and said that, without a lender of last resort, interest rates would be even higher than he estimated in his paper the year before. That clearly shows that even he is changing his mind on the matter. As I said, I would like to know what the figures that I read out are based on and, in particular, whether they assume any particular currency arrangement.

Dr Angus Armstrong: That is a great question, and a fair one.

We based the original estimates in our paper that was published in October last year on a calculation using figures for all the countries in the euro zone between 2000 and 2012, and we tried to take account of the crisis by taking out all of the crisis countries. We used the euro zone because, at the time, the proposition that we were testing concerned a situation that would pertain under a full formal monetary union, with one central bank acting for all members. In that context, the euro zone was a useful way of estimating the figures.

The policy-making committee of the European Central Bank has a representative from each of the national Governments, all of whom have an equal vote and a mandate to vote in the interests of the union, not their national interests, which means that there really is a shared central bank. The initial spreads that we proposed were calculated under that notion of a shared central bank.

In the follow-up paper, we took a position of there not being a central bank for all countries. Under a currency arrangement that involves dollarisation, there is a different type of central bank. It does not have that shared policy-making position. That model involves using somebody else's central bank, which means that, clearly, some of the risks change. That is why I would say that, under dollarisation, the estimate is likely to be higher than it would be under the first illustration, which assumes a shared central bank.

There were two different examples.

Malcolm Chisholm: Are you saying, therefore, that, in your estimation, although the borrowing rates would be higher even if there were a monetary union, they would be even higher still if there were some other monetary arrangement?

Dr Angus Armstrong: To be clear, under a formal monetary union, with a shared central bank, we estimate a spread of 72 to 165, with the central point being 120 basis points. Those estimates remain, under that model. If you do not have that model, and you have an informal currency union with no shared central bank, the spread of interest rates is likely to be higher.

Malcolm Chisholm: Basically, I have two questions. One concerns interest rates and the other concerns the general fiscal situation. You say that you have carried out a 10-year fiscal simulation—Jo Armstrong has obviously done a lot of work on that as well—and you state that

"a newly independent Scotland would need to engage in more than 3% additional fiscal tightening over and above what the UK Government is already proposing."

Does that also assume a monetary union? If so how would it be different if there were no monetary union?

Dr Angus Armstrong: In that simulation, we assumed a formal monetary union, with the spread of interest rates that I outlined, and we took the Maastricht definition of debt as the starting point. On that basis, we proposed a completely hypothetical situation in which we were trying to get down to a debt-to-GDP ratio of 60 per cent in 10 years' time. It could quite justifiably be said that that figure is not reasonable, and that we should go for a ratio of 80 per cent. If you do the calculation again on that basis, you will come out with new estimates. Similarly, if you go for a ratio of 40 per cent, you will come out with other estimates. However, we used the ratio of 60 per cent because that is what the Maastricht criteria say that a country must have in order to get into the euro zone. On a purely mechanical basis concerning what sort of primary surplus Scotland would have to run in order to get to that number, there would end up being a tighter fiscal policy than that which is currently proposed by the UK Government. It is a very mechanical exercise.

Malcolm Chisholm: What does 3 per cent mean in practice? I suppose that it depends on how many years the process takes. However, what sort of fiscal tightening in any one year could that involve?

Dr Angus Armstrong: It depends on how fast you want to do it. Our calculations assume that you do it immediately. If you take longer to do it—for example, if you spread 0.5 per cent over six years, plus a bit for the interest that you are paying—the amount that you are going to have to tighten eventually will be a greater figure than that. The calculation assumes that you do it immediately and then keep it there.

Malcolm Chisholm: I cannot really ask too many questions because all my colleagues are champing at the bit, but I want to bring in Jo Armstrong, who had a rather similar analysis of the fiscal situation.

We have talked about a no-debt option. The context in which the Scottish Government has talked about that is one in which we do not pay the debt because we do not have the monetary union. The question that intrigues me, in that case, is why the Scottish Government is sticking with a monetary union if the alternative is no debt and, presumably—as you advocate, Dr Armstrong—an independent currency. What are the negative consequences of that option? Jo Armstrong says:

"Such a bargaining position implies that the Scottish Government believes the long term negative consequences of a separate Scottish currency (or pegged to sterling without an official monetary and currency union) significantly outweigh the short term potential benefits of starting off with no debt and a near balanced budget".

In a situation in which there is no debt and no currency union, what would the negative consequences be? The Scottish Government must think that they are pretty profound, or that would be quite an attractive option, would it not?

Jo Armstrong: It seemed interesting to us that we had not seen that proposed as an alternative option. Again, I think that it would be part of the opening bargaining position after a yes vote. One of the obvious negative consequences would be transactions costs, with businesses that trade with the rest of the UK facing higher costs if sterling were being used in the dollarised context. There would also be additional costs to the Scottish Government's reserves in terms of managing stresses and strains around its exchange rate policy. Those two effects, which we do not have figures on, would presumably be more significant than the benefits of having a zero-debt position.

Malcolm Chisholm: I would be interested in hearing your position on that, Dr Armstrong. You do not think that a currency union would be good for anybody, but what would the implications of that be? Does that mean that you would just have to accept the higher interest rates that would result from that?

Dr Angus Armstrong: If I follow you, this idea of zero debt—

Malcolm Chisholm: Leaving aside the issue of the zero debt, you say that it is not in Scotland's interest or that of the rest of the UK to have a monetary union after independence, and that having a separate currency would be better. However, there must be negative consequences of that position in terms of what you have said about interest rates. Is that not the case?

Dr Angus Armstrong: It has to be in both nations' interests to have a full monetary union. That is a pretty obvious point. A full monetary union means a shared central bank. A shared central bank, almost by definition, means that it has got to be in both countries' interests.

Professor Armstrong pointed out that there would be higher transaction costs to having a new currency. That is completely correct, but it has to be put in context for the rest of the UK. You have to look at it from its angle if you need both sides to agree.

10:15

The bigger cost is what happens if something goes wrong. That is the risk management approach to considering different exchange rates. Let us take S&P's figures. Under independence, you are starting off with a 77 per cent debt-to-GDP ratio. Professor Armstrong's projections set out deficits to 2018-19—I think that that is as far as they go. If you are using somebody else's currency, it is not unreasonable to ask what happens if there is a big, nasty shock. These things do happen. What is your room for manoeuvre? Arguably, it could become quite limited. Therefore, the prudent and reasonable thing to do—rather than getting there and then worrying about it—is to bring these things up at the beginning, which is where we are now, and ask what would happen in that situation. As you have seen in some countries around the world, the costs of getting to that position can be extremely high. The costs of these sorts of problems can be way more than transaction costs, which is why we came to the conclusion that we did.

If you do not have formal monetary union, it would depend on what that the alternative arrangement looks like. If it is something like dollarisation, which seems to be the converging position, would that mean that an independent Scotland would pay higher interest rates than the mid-point of the range, which we estimate is 120 basis points? If that is the case, the risk is that the rates would be higher.

Jim Cuthbert: I would like to clarify a point that Malcolm Chisholm made when he said in his initial remarks that one thing that we had neglected was the relatively higher levels of public expenditure in Scotland at present. Yes, indeed, public expenditure levels are relatively higher in Scotland, but the existing levels of public expenditure are taken into account in the calculation of the £150 billion. In other words, we are fully bringing into that the level of public expenditure in Scotland that is funded through Barnett. That is allowed for in our calculation.

I have two other quick comments on the discussion. One is the point that I have already made, which is that in the existing GERS deficit, there is something like 2.3 or 2.5 per cent of slack, first of all arising from quantitative easing and, secondly, arising because of the implicit assumption that Scotland has a 2.2 per cent GDP expending on defence. An independent Scotland might well choose not to replicate that level, and similarly for overseas aid. There is a level of slack there.

The other thing about the overall discussion is that it is being conducted as if the UK position was risk free. In fact, the fiscal position of the UK is extremely dodgy. Stephen Nickell made the analogy that the UK is like a large bank. It has international assets and liabilities out of the range of any comparable country. International assets and liabilities of the UK are 700 per cent of GDP and growing at 8 per cent per annum compound. That is not a sustainable position, so there is a major risk of a repeat of systemic crisis in the UK economy within, let us say, the next eight to 10 years. One cannot abstract the discussion of Scottish independence from the consideration of that kind of risk.

Malcolm Chisholm: We do not have time for a big discussion and I would like to see your figures, but in general terms, if you look at the figures over the past three decades, the extra revenue from oil is balanced off by the extra expenditure in Scotland. I do not understand how you get such a big differential from that.

Jim Cuthbert: I am happy to give you a note on that. The extra expenditure has been taken into account, as indeed it has in the independent calculations by the fiscal commission, and by MacIntyre-Kemp, who came out with conclusions that were entirely consistent with our conclusions about the size of the Scottish oil fund.

Jamie Hepburn (Cumbernauld and Kilsyth) (SNP): I return to the starting position for an independent Scotland in relation to debt. We know that debt has not been issued in the Scottish Government's name. As Dr Armstrong said, the UK Treasury has confirmed that it will take on responsibility. The convener referred to the precedent for debt remaining with the capital of the state that took on that debt, and Jim and Margaret Cuthbert made the point that the debt position might be overstated. I think it was Dr Armstrong who made the point that walking away from debt is unreasonable. Surely you all accept, in that case, that the Scottish Government is being reasonable in its approach to the matter.

Dr Angus Armstrong: Do you mean the fact that the Scottish Government has said—as far as I follow it—that it thinks that it is right to take on a fair and equitable share?

Jamie Hepburn: Yes.

Dr Angus Armstrong: The Scottish Government is absolutely being reasonable. The term "fair and equitable" is nice and big and open, but I believe that the proposition of a population share of debt is quite widely discussed. That would constitute a "fair and equitable" starting point in the negotiation. You could make arguments both ways from there.

Jamie Hepburn: It is, though, reasonable that the Scottish Government has said that it will take on a share of the debt, is it not?

Dr Angus Armstrong: Yes.

Jamie Hepburn: Do you all accept that?

Jim Cuthbert: No.

Dr Angus Armstrong: If the Government's position was not to take on a share of the debt, that would be very unreasonable.

Jamie Hepburn: The Cuthberts might think that the Government is being too reasonable. I suppose the point is that it is not being unreasonable.

Jim Cuthbert: One does not enter into a negotiation by offering up one's hostages to fortune. One enters a negotiation with one's maximal position. As I said, as an outsider one can only interpret the position on debt that has been taken in the white paper as being a position that has been taken under the assumption that the Government would be met with a reasonable converse negotiating position from the other side of the table. It is quite clear that it will not be met with a reasonable converse position, so my view would be that the position in the white paper now falls.

Jamie Hepburn: Your position is that the Scottish Government is being reasonable and the UK Government is being unreasonable.

Jim Cuthbert: The Scottish Government started negotiations being entirely reasonable, but it was met with an unreasonable response. I do not speak for the Scottish Government and I do not know what the thinking is, but at that point, the Scottish Government would have been perfectly justified in saying, "The reasonable position that we adopted in the white paper is now withdrawn."

Jamie Hepburn: So we accept that the Scottish Government was being reasonable. That is a useful position to get to. Thank you.

Jim and Margaret Cuthbert touched earlier on quantitative easing; I know that you have set it out in your paper. Will you talk about that a bit more in relation to the calculation of the UK's headline debt figure? Could you put a bit more on the record about what you meant when you were talking about quantitative easing?

Jim Cuthbert: The amount of UK gilts that have been quantitatively eased at present are £375 billion-worth, which amounts to just over 30 per cent of the current UK headline debt; not only that, but the interest on that circulates back to the Treasury. In the actual interest payment in GERS, Scotland has been given something like £4 billion as being its population share of current UK debt interest payments. In fact, 30 per cent—almost £1 billion—of that should be subtracted because it is not a payment that is actually made by the UK Government at present, given that it circulates back immediately to the Treasury. The logic of that, in terms of the national accounts, is that quantitative easing is a temporary measure, and the UK Government is trying to give a view that is abstracted from that temporary measure.

However, the point that we are making is that it is now looking increasingly unlikely that quantitative easing will be reversed. We give a quotation to that effect from Ambrose Evans-Pritchard, but even the governor of the Bank of England now refers to the possibility of relaxation of quantitative easing rather than to the fact that it will take place. We saw the difficulty that occurred in the markets when the Federal Reserve System said that it might reverse quantitative easing. It is looking extremely unlikely that it will be reversed. I do not know whether it will be reversed, but we certainly cannot take it just as being a fact. It is a purely temporary intervention and the headline debt should stand as it is.

Margaret Cuthbert: Quantitative easing has dynamic effects on the rest of the economy. It has fed an asset bubble that we are all experiencing now, especially down south, in which house prices and all other asset values, such as the stock market, are rising incredibly. We have a big bond bubble, too, that is affecting our future. Although we have worked out the effects of quantitative easing on the size of debt, it is also having an effect on the entire workings of the economy, so that what looks like an improvement in the UK economy is very fragile. As we have seen, per head it is really not an improvement at all.

Jim Cuthbert: Andy Haldane, who is director of financial stability at the Bank of England, made an interesting comment at the House of Commons Treasury Select Committee meeting of 12 June 2013. He said:

> "Let's be clear, we have intentionally blown the biggest government bond bubble in history."

That is where we are, so we need to be vigilant about the consequences of that bubble deflating more quickly than we might otherwise have wanted. Andy Haldane also singled out the consequences of quantitative easing as being

> "the biggest risk to global financial stability right now".

Jamie Hepburn: Thank you, that is helpful.

Obviously I hope that this scenario will not happen, but let us say that there is a no vote. Your paper states:

"It is in fact difficult to see how Barnett can survive in its present form."

I believe that Jo Armstrong has also said something to the Economy, Energy and Tourism Committee in relation to that.

The Convener: Hold on a wee second. Before you go on, I should let Dr Armstrong comment on quantitative easing. Professor Armstrong can come in after that.

Dr Angus Armstrong: Yes. First, I feel as though I am beginning to sound a bit like a bogeyman, just saying no to everything. I think that the idea that the QE assets can be somehow crossed off is erroneous. The idea is just false, frankly. I have a degree of sympathy with some of Margaret and Jim Cuthbert's points on either the intended or the unintended consequences of the whole QE programme but, with respect, that is not quite the issue. The question is whether the assets should be taken off the debt.

The assets are held in the asset purchase facility, which is a wholly owned subsidiary of the Bank of England. If they were somehow to be crossed out, the Bank of England would have a hole in its balance sheet, so we cannot just cross them out. Another suggestion is that maybe they will not be crossed out or bought back—instead, as they mature, they will just disappear. However, as they mature, somebody must be repaid, otherwise that hole in the balance sheet will be there again.

On the last day of the bond, you could go and knock on the Government's door and say, "The bond is maturing, I would like my £1,000 per face value—my £375 billion—back now please, as you have promised on this gilt, or you are defaulting." I assume that because the UK Government said that it would honour all its debt, it will have to pay. However, as the convener pointed out earlier, Governments do not have that sort of money in their pockets. The Government would have to issue new bonds of exactly the same value—£375 billion. Therefore the amount will not just go away unless we put a hole in the Bank of England balance sheet.

The only way that it could be done is if the UK Government was to issue gilts to the Bank of England for which the compensation would be that there would be a liability to the Government on the Bank of England's balance. The Government could then say, "You know what? We're walking away from this—we're writing it off." That would be direct monetisation.

However, that is not what is happening. The relationship is not with the Government; it is with the private sector. The assets that have been bought by the Government have been sold by the private sector and through their sale reserves have been accumulated that are held in the Bank of England. Those reserves are the money that is owed to the private sector. To just somehow cancel that amount or not repay it would take £375 billion out of the private sector. That would be default, so it is just not correct to say that we could just wipe out the amount or that it will mature and go away or whatever else.

Jo Armstrong: I think that it is right to say that the financial markets are still sick. We still do not know how the financial markets will operate effectively in the future without maintaining at least this level of QE, which was brought in to maintain liquidity for the banking sector and to stop deflationary effects. Although we might think that we are seeing inflationary effects at the moment, QE was done for that reason.

There is certainly enough debate around the asset bubble issue to be able to argue that some of the house price effect is real, because of a lack of supply, rather than because of QE.

Jim Cuthbert: I have two points to make. One is that we have wandered into "Alice in Wonderland" territory here. To say that there is a hole in the balance sheet of the Bank of England and that somehow, that is a problem for Scottish independence, is ludicrous.

The financial weakness of the UK is being used as an argument for why Scotland cannot be independent, but it is the other way round. If there is a huge hole in the Bank of England's balance sheet, that gives us more reason to want to get away from it.

Secondly, there is the war-loan solution. Re-denominating the maturity of the assets to be infinite—in effect, making a war-loan on them—would solve the problem. That would paper over the hole in the Bank of England's balance sheet forever.

10:30

Jo Armstrong: I am sorry, but let us be clear: there is no hole in the Bank of England's balance sheet. The proposition that there would be a hole is based on the hypothetical idea that all the quantitative easing transactions and the asset that the Bank of England has through the asset purchase facility would somehow be set to zero. It does not have a hole in its balance sheet; let us be absolutely clear about that.

Jim Cuthbert: No—the hole can be papered over. It is not we who are saying that QE will never be reversed. Serious commentators are saying that the probability is that it will not be reversed. I quoted Ambrose Evans-Pritchard: he is a serious right-wing economist who writes for *The Daily*

Telegraph, and if he is saying that QE will never be reversed we must take that seriously.

The Convener: Okay. We will call a halt to that discussion. Jamie Hepburn will take us back to Barnett.

Jamie Hepburn: Back to Barnett, indeed. I will not go through the preamble to my question again. The point that I was making is that the Cuthberts refer to the Barnett formula in their paper, saying that they foresee difficulties for its surviving in its present form, and Jo Armstrong has said something broadly similar. You suggest that there could be challenges to the Barnett formula in the future. What change do you anticipate being made to the Barnett formula in the event of a no vote, and what could the implications be for Scotland's finances?

Jo Armstrong: I am on record as saying that I think that the Barnett formula is up for negotiation. It is a statute of political negotiation, and it is interesting to see how what politicians negotiate then influences what we end up getting.

I think that the Barnett formula is up for negotiation for a variety of reasons. It is not as transparent as the word "formula" might suggest. It is principally a black box, in many respects, and as we start to unpick it—the Cuthberts have significantly improved our understanding of it—the more we look, the more we find. Not that long ago, the Welsh Government identified that there was an asymmetry in the treatment of, for example, non-domestic rates, which then forced a change in the Barnett formula for the Welsh Government. It is also likely that the Welsh Government will argue that Wales should get more on a needs basis.

If you are going to have a fixed budget—we are actually looking at budget cuts rather than fixed budgets—that suggests that there will be a change to the current Barnett arrangements. You could argue that, as Scotland's North Sea tax revenues begin to decline, it will become harder to justify Scotland's receiving a higher per capita share through the block grant. Also, the tax powers that are coming to Scotland through the Scotland Act 2012 will create a change in the Barnett formula.

The Barnett formula is a creature of the politicians and is always up for negotiation at the margins. I suspect that we are not now talking about marginal change, but I do not expect to see significant change overnight. It will evolve as the negotiators—the politicians—negotiate what is acceptable both to their local politicians and to their national Governments.

Jamie Hepburn: Ultimately, it is not exactly a process of negotiation, is it? The UK Government could just decide what change to make, could it not?

Jo Armstrong: The Barnett formula has not been "just decided"; it has been developed as a consequence of negotiations.

Jamie Hepburn: What are the likely consequences for Scotland's public finances? I know that that is a very hard question to answer.

Jo Armstrong: It is important to note that the Barnett formula is not just the per capita share of funding for the equivalent spending departments. It gets circumvented and there are times when Scotland receives funding that is not just Barnett consequentials, as do other parts of the UK. The allocation of funding from the UK to Scotland is not based only on the relatively arcane Barnett formula arrangement; it also depends on strong negotiations. Since the Barnett formula was established, it has principally been beneficial to Scotland because of strong negotiating by Scotland, which I assume will continue to be the case.

Margaret Cuthbert: As Jo Armstrong said, although the Barnett formula is the main thing that affects the departmental expenditure limit, there are ways round it, although those were tightened up considerably in the 1990s. When we first did quite a bit of writing on the issue, we referred to it as the Barnett squeeze. At the time, the underlying conditions that affected the Barnett formula were squeezing Scotland's finances relative to those of the rest of the UK, but things have changed with the recession and the growth of the population in the rest of the UK. The effect of the Barnett formula is not fixed in time. At the moment, we are benefiting from it.

Jamie Hepburn: You say that we are benefiting from the Barnett formula, but what happens if that changes? That is the question. In your submission, you say:

> "It is ... difficult to see how Barnett can survive in its present form."

What do you think is likely to happen?

Margaret Cuthbert: It is likely that we would get less.

Jamie Hepburn: Is it possible to quantify that?

Margaret Cuthbert: The trouble is that the Calman changes will affect the formula and the new suggestions by Labour will affect it even more. We have not done a simulation model.

Jim Cuthbert: The interaction with the Calman measures is important. A point that we make in our submission is that changes have been suggested to the Calman mechanism. If the Calman threshold were to be increased—if it went up from 10p to, say, 15p—that would make one of the problems that are associated with Calman much worse; I refer to the instability that is associated with fiscal drag, which would arise with any change in the proportion of tax that came from the different bands. Any change to Calman would have to be handled with great care.

To return to the Barnett formula, it was only when we started to produce the figures for our submission that we realised how serious the position is. The normal view of Barnett is that, if nominal expenditure in England is rising, we will get convergence towards equality of per capita spending in England and Scotland, but once we bring relative population growth into consideration, that simple picture becomes clouded. There is convergence to a limit when expenditure growth is greater than relative population growth, but that limit is not necessarily equality.

The example that we give in our submission really surprised us. According to our model of Barnett, if relative population growth was at its present level of about 1.003 per cent and there was 1 per cent growth in nominal expenditure, in the long run per capita spend in Scotland—the amount of DEL per head spent on devolved services—would tend towards a limit that is 40-odd per cent higher than that in England. That convergence would be relatively slow, but after expenditure growth has resumed, as long as it remains low, we would be heading in the wrong direction. That is why we said that, in the current circumstances, we regard Barnett as being, in effect, doomed.

It is unclear what would replace Barnett. That would depend on a political negotiation. In the present circumstances, the scrapping of Barnett would not be good news for Scotland.

Jamie Hepburn: Thank you.

My final question picks up on Angus Armstrong's point about countries that handle the volatility of oil and gas. Norway established its oil fund in 1990 and made its first payment into it in 1996. The fund is now worth some £500 billion. Should the UK Government have established an oil fund? Why has it not done so? That is a question for everyone.

Dr Angus Armstrong: The question is whether the UK should have established an oil fund, so we are doing some historical consideration.

Jamie Hepburn: Indeed. I just asked about the future and the position is somewhat unclear, so I am now asking about the past.

Dr Angus Armstrong: Looking back in history, I think that the answer to that question is that there is merit to the suggestion that that would have been a good idea. Tough choices would have had to have been made, because the money was used for something. However, on my reading of history, the setting up of an oil fund would have been a good idea.

Jim Cuthbert: I think that I can answer the historical question with a quotation from the Cabinet minutes of 15 December 1977:

> "Above all the creation of an oil fund would play into the hands of the Scottish Nationalists for whom it would become a major political target."

That is, explicitly, why we did not get an oil fund.

Jamie Hepburn: Should we learn the lessons of history and seize the opportunity to have such a fund in future?

Jo Armstrong: If we set up a fund now, we will have to explain where we are cutting spending, because at the moment we are running a fiscal deficit. Yes, we should have an oil fund; certainly, if we are independent, we should seek to have a reserve to help to support whatever currency arrangements are put in place and deal with shocks. However, to do that we need to explain where the spending comes from, given that we have a fiscal deficit.

Jamie Hepburn: If we did not set up an oil fund in future, would that be a missed opportunity?

Jo Armstrong: It is needed if Scotland is independent and a significant proportion of its tax revenues and therefore its economy is related to hydrocarbon activity.

Iain Gray: The white paper is clear on where the resources would come from for a stabilisation fund such as Jo Armstrong described. It says that the money would be borrowed on the money markets. Does the panel think that that is a good idea?

Jo Armstrong: The pros and cons would have to be weighed up, given that we might be borrowing at one rate and generating a return at another. As long as the borrowing rate is lower than the investment rate, borrowing to put money away is a good thing, but if it is not lower, that approach is called into question.

Borrowing for that purpose would mean not borrowing for something else, and we have a fiscal deficit, which means that we need to borrow money. There are trade-offs to be made and we need to understand what we are using the funding for.

Jim Cuthbert: The discussion is in danger of becoming a little static. The whole point of independence is to change things. The ability to establish an oil fund would depend on what could be done with the Scottish economy in the medium to long term. That is not about current levels of taxation—it is not necessarily about altering current levels of taxation; other things could be altered.

An independent Scotland would want to use things such as licensing conditions to ensure that more of the benefits and multiplier effects of oil-related expenditure stayed in Scotland. Scotland currently has 85 per cent of the oil extraction and 45 per cent of the jobs in the UK. One would want to alter that position, through licensing conditions, deals, taxation and so on, so that the associated tax revenues altered and the general economy altered. The ability to establish an oil fund would be critically dependent on the ability to make that sort of change.

Dr Angus Armstrong: I answered the question about history, but Jamie Hepburn then asked about the future. What happens in future depends on what return is expected on the assets that are put in the oil fund versus the amount that is paid on the borrowing. There is not much point in taking a big mortgage and having a lot of debt if we simply leave money in a bank earning a very low interest rate—we are much better off paying off the debt. The relative returns would have to be considered before a conclusion could be reached.

Margaret Cuthbert: On Jamie Hepburn's original question, according to the most recent figures from HM Revenue and Customs, more than £400 billion has been paid in tax from oil—cumulatively, from all its different forms. It is clear that the UK Government has sometimes used the taxation of oil for short-term political reasons. George Osborne has changed the tax situation, and his most recent changes meant that old oilfields were just stopped—we lost quite a bit at the time.

The intention behind having an oil fund is not just to protect the resource so that it can be used by future generations but to use it to extend research and development in Scotland and produce the engineers and so on who will be at the forefront of coping with oil, worldwide. We have not been doing that.

Jamie Hepburn: The Scottish Government has said that it will establish a fund when the conditions are right. We should consider the Norwegian precedent: the fund was set up in 1990 but the first payment into it was not made until 1996. That seems to be a reasonable approach, does it not?

Jo Armstrong: I do not think that you can compare conditions in Norway with the conditions that we are talking about for Scotland. Norway had to set up its fund because oil was having a serious detrimental effect on its non-oil activities. It decided not to spend its oil money and to put it into a fund, so that there would be less of an effect on exchange rates and interest rates. The Scottish Government has said, quite rightly, that it will build an oil fund as and when conditions are suitable.

10:45

The challenge with what Margaret and Jim Cuthbert suggest—and I fully endorse the idea of trying to maximise the value of North Sea revenues and North Sea activity staying in Scotland—is that we have to think about European Union procurement rules and whether we could actually do what they suggest through licenses. That is clearly something for negotiation.

However, there is also the fact that the North Sea is an ageing asset. It is an environment where the pipelines, the platforms, the boats and the servicing arrangements are ageing and will at some point have to be replaced, if you do not exploit it now. If the tax regime is not accommodating, they will be replaced sooner or will be closed down. There is an idea that we should do something in the medium to longer term, but the challenge at the moment is to exploit what is possible from the North Sea now because things are ageing and it is costing more to exploit.

The Convener: Margaret Cuthbert has a final point. After that we will move on to a question from Gavin Brown.

Margaret Cuthbert: What puzzles me a great deal about the white paper and what Jo Armstrong has just said is that in the negotiating phase—should we get a yes in the referendum—people will say, "We will be going into the EU and we will be doing this, that and t'other." At the negotiating stage, we should surely be throwing the net wide. One possibility is that we do not go into the EU and, in fact, consider the European Free Trade Association, in which case we are not bound by procurement rules. The general point is that in its white paper, the Government seems to be taking a very definite stance about things that we are going to do instead of looking at different potential ideas.

Gavin Brown (Lothian) (Con): My first question is purely for clarity. Margaret Cuthbert mentioned the figure of £400 billion. Can you clarify where that figure comes from and exactly what it represents?

Margaret Cuthbert: The figure comes from one of the latest HMRC papers on oil and gas.

Gavin Brown: What does the figure represent? Is it the cumulative tax?

Margaret Cuthbert: It is both cumulative and covers all types of tax so, for example, it covers the petroleum tax. It covers anything that the UK Government has got from offshore oil in the UK, not only from Scotland.

Gavin Brown: Since when?

Margaret Cuthbert: I think that the first oil came out in 1975.

Gavin Brown: So it is a cumulative figure.

Margaret Cuthbert: Yes, and it is in today's prices.

Gavin Brown: My next question is about issue 5 in Jim and Margaret Cuthbert's submission. You refer to the slightly different income tax profiles of Scotland and the rest of the UK and conclude that that points to the potential need for Scotland to consider new forms of taxation, were we to be independent. Can you expand on that? What forms of new taxation do you have in mind?

Margaret Cuthbert: I will start with the income tax base itself. You will all be very familiar with the huge, long tail in income and in income tax for the UK. More than 11 per cent of income tax—the figure varies and is sometimes higher—is raised from a very small number of people. We do not have that tail in Scotland, so if we were independent and used the same system of taxation as is used in the UK, we would not have the extra money coming in. That makes it seem as if Scotland would be in a poor way. Instead, we look at it as meaning that Scotland is not so vulnerable, because, as you will know, every time that the UK Government tries to change taxes—for example, by raising the rate to 40 per cent or putting a tax on bonuses—people are able to change their pattern of taxation. Therefore, the Government does not raise the tax that it thinks that it will get, and we are extremely vulnerable to what is happening in the financial sector.

The rest of the UK is not in a happy position now, as a result of being so dependent on income tax. Scotland does not have that problem, but we do not have that vast amount coming in. We think that those funds are as volatile as oil—if anything, they are more volatile, because the UK will not necessarily continue to have such a huge financial sector.

We think that there are a number of other areas in Scottish life that are not taxed at present, which is to the detriment of Scottish life. One of those areas is land. You will know that people from any other part of the world can come in and buy up land in Scotland, Ireland and the rest of the UK, and that there are very few, if any, restrictions on that. We are probably unique among countries in the world in allowing that to happen. It has its consequences, in that land prices are higher in Ireland and the UK than elsewhere in the world. We must think about that. Politicians might think about having a land value tax as a possibility.

We have seen a huge increase, especially up in Aberdeenshire, in the number of what are called lifestyle properties, which are actually taking away from agricultural land and production. Again, politicians have to think about whether that is what they want and whether we should be taxing land so that we increase its efficiency, ensure that it reflects the type of Scotland that we want and at the same time plug a hole so that we have the type of spending environment that we want.

Another huge area is our assets. Jo Armstrong pointed out very clearly what we all know, which is that our assets are owned by other people to a large extent. For example, in whisky, the Johnnie Walker label is owned by a small company over in Holland. Somehow or other, we have to start to get such assets, which are Scotland's assets, to produce a return in Scotland. As far as we are concerned, that argument holds whether it is about coffee shops, whisky or land, and within the EU there are means of doing what the argument proposes we do.

Gavin Brown: You laid out the advantages and disadvantages of the income tax scenario, but you pointed out that the disadvantage is that there is a swathe of money that is not coming in. Have you looked at how large that amount of money would be and, therefore, how much more we would need to collect from a land value tax or other measures?

Margaret Cuthbert: No, but it would not be hard to do that. I am quite prepared to do a note, if you would like that.

Gavin Brown: Okay. That would be helpful. Thank you.

Jim Cuthbert made a comment when we discussed not including QE in terms of the overall debt level—I think that he said that it could be "papered over". Are other economists or experts out there saying similar things—that an issue of such magnitude could be, to use his expression, "papered over"? It was certainly news to me.

Jim Cuthbert: Certainly, there has been quite a bit of comment in the press about whether quantitative easing will ever be unwound and about how that could be done—other than that, I do not know.

Gavin Brown: So there are others questioning the extent to which it could be wound down. I think that you suggested something different with the expression "papered over". Are others saying that, or is it your view?

Jim Cuthbert: If it was not wound down, something would need to be done. The obvious thing would be to extend the maturity of the relevant assets. However, I am not aware of academic work on how that might be done.

Gavin Brown: Okay. Let us move on to another issue.

On the starting point or basis for dividing debt, I think that the suggestion in Jim and Margaret Cuthbert's paper is that the 1980 position should be used. However, Jo Armstrong's paper—the CPPR paper—makes the point that there are no examples, or at least she was not able to point to any, of what she calls "historical disentanglement". Are there any examples of the historical disentanglement of countries in which they have gone back to 1980—or a different year—rather than looking at the position at the time of independence or change? Is there a precedent? Any panel member can answer that question.

Jo Armstrong: I think that Dr Armstrong can take that question.

Dr Angus Armstrong: In the Quebec situation, four different ideas were proposed: affordability, population, a slightly archaic formula and another one that, I think, had a degree of looking backward. Apart from affordability and population, the other two measures were proposed by people who took positions, if you know what I mean.

The Convener: You mean historical positions.

Dr Angus Armstrong: Yes. It was not surprising that one formula produced a lower number and the other produced a higher number. Of course, the proposal did not go through so we do not know how things would have come out. It is academic, but that is the only place that I know of where people have looked backwards.

Jim Cuthbert: I am not aware of any such precedent, but each case is individual in its own right, and necessarily so. We should not expect to find a precedent that we can just wheel out and apply to any case.

Gavin Brown: I was just asking whether there was one.

Dr Armstrong, you suggest in your submission that there would need to be fiscal tightening if Scotland were independent, and your view on the projections is that we would need greater fiscal tightening than the rest of the UK if we wanted to reduce debt, deficit and so on.

The white paper has figures only for the financial year 2016-17, but those figures suggest that the net fiscal balance in Scotland would be healthier than that of the rest of the UK in that year. On the most up-to-date projections that any of the witnesses has seen, can that position be supported? Are there projections that suggest that Scotland's net fiscal balance would be healthier in 2016-17?

Jo Armstrong: In the work that we have been doing, we have been relying on official data, so we are not looking to adjust arbitrarily. However, we have done a piece of work that says that if we took out defence spending, made it equivalent to Ireland's level of spending, achieved the upper range of the now accepted historical set of figures from the Scottish Government on North Sea tax revenues and used a lower share for international aid financing, we could see a surplus by the end of the projection period, which I think is 2018-19—I cannot remember if it is 2016-17. Therefore, we could see a surplus but it would require quite substantial adjustments.

I know that Margaret and Jim Cuthbert have suggested that defence and international aid spending are open for debate. At the moment, the issue is that the white paper suggests spending the equivalent amount primarily on defence to that which is currently assumed in the GERS figures, so it is not clear how there will be a significant and sustainable surplus.

Gavin Brown: On the issue of fiscal tightening, could Dr Armstrong state for the record his view of the best projections? I accept that they are just projections, but on the most up-to-date projections, what level of fiscal tightening would be required?

Dr Angus Armstrong: The exercise that we show in the evidence that we have presented was very specific. To reiterate, we assumed that in 10 years, having gained independence, an independent Scotland would target a 60 per cent debt to GDP ratio. That is our hypothesis. If you do not agree with that, you will get a whole different scenario. It would be perfectly reasonable to think that the ratio should be lower or higher, but we used the 60 per cent ratio to get our estimate of GDP fiscal tightening of 80 per cent or slightly higher. That would be tighter than the presumed tightening in the UK, but it is just a scenario.

We have not done an exercise on what the fiscal tightening will be by 2016-17. We have not looked forward one or two years. We have tended to look further out than that because we are always being asked the question about the sustainability of the current regime, and that has been paramount in our approach.

11:00

Jo Armstrong: Page 26 of paper 1 contains table 4, which shows our projections to 2018-19 on the basis of the most up-to-date GERS figures. That indicates the fiscal tightening that would be required. The top line shows that, by 2016-17—if that is the year that is chosen—Scotland's fiscal deficit would be about £9.4 billion in cash terms. That equates to about 5.5 per cent of GDP, in comparison with a UK figure of 2.4 per cent of GDP.

By the end of the forecast period, when it is deemed that the current fiscal austerity measures will have delivered the fiscal targets that the UK chancellor has set, the UK would be in fiscal surplus, whereas Scotland would still have a fiscal deficit of about 3 per cent of GDP. That is equivalent to about £5 billion to £5.5 billion of additional cuts to get us back to a fiscal surplus.

Gavin Brown: I put the same question to Jim and Margaret Cuthbert. Do you think that fiscal tightening that is over and above the UK level would be required, that no fiscal tightening would be required or that the position is somewhere in between? Do you have a view on the level of fiscal tightening?

Margaret Cuthbert: All the figures are based on the OBR's oil and gas forecast. Jo Armstrong said that the Scottish Government's figures are historical and need to be updated, but there is a huge gap between the two sets. Many people in my position regard the OBR's figures as being far too conservative. The Department of Energy and Climate Change has said that its figures are conservative, and the Oil & Gas UK people have much higher figures, so I am chary about the figures.

If we get independence, we must accept that we will move into a transition phase. In a transition phase, there is uncertainty, so costs are likely. However, those short-term costs are much more likely to be well worth enduring, because of the returns that will be likely in the longer term.

I will give an example of one big return. We must remember that only 38 young Scots men in every 100 who go to university in Scotland manage to get a graduate job in Scotland. We export an awful lot of them. We must also remember that the levels of those who are not in employment, education or training are extremely high, particularly in poor areas that suffer multiple deprivation.

There is a lot to be gained in the long term. We are looking at too short a period. We might well have to have fiscal tightening in the short term, but the longer-term prize is large.

One thing that could help us on our way and which we have put into quite a lot of our papers is the fact that utility pricing in the UK is following a wrong model. The National Audit Office in England has finally paid attention to that; Jim has done work on the issue. We pay far too much for our utilities. If utility prices were fixed, that would fundamentally affect the whole Scottish economy and therefore our ability to generate taxes.

We hope that a proactive Government would be in place, so that the position would be radically different from the 10-year projections that Angus Armstrong gave, as we would be much more involved in getting a big amount of research and development from our natural assets and would ensure that we got the tax that we ought to get in our own country.

Jim Cuthbert: Even if it is not assumed that Scotland will be debt free, if we bring in the quantitative easing point and the defence point, the fiscal deficit is probably overstated by something like 2.3 or 2.5 per cent of GDP. That would have to be offset against any potential tightening.

We are making comparisons with the UK. As far as I can see, the work that has been done on the UK's position takes the OBR forecasts of GDP growth. In taking those forecasts as a given, we are neglecting a point that we have discussed previously at the committee, which is the nature of the risk assessment that the OBR forecasts. As I have argued in the past, since the OBR accepted a forecasting remit, it has effectively understated the risks attaching to the UK economy.

The OBR does that for two reasons. The first is that, if an organisation is forecasting in a policy-related environment, it will almost always assume a successful policy. The OBR simply assumes that, by the end of its forecast period, the UK economy will be back on a trend path of growth. That is simply an assumption—it does not have much evidence for that.

Secondly, if an organisation is forecasting, it tends to neglect the possibility of black swan events. I have indicated why, in my view, in terms of the UK's international balance sheet, a major correction is almost inevitable within, say, the next nine or 10 years. The possibility of that occurring is simply neglected in the OBR forecast—and quite rightly: if an organisation is forecasting, it cannot forecast black swan events.

For those two reasons, the risks and uncertainties attaching to the UK position are completely understated if we take the OBR forecast as a given when setting out an OBR-based benchmark.

Dr Angus Armstrong: In our projections, we had to assume a growth rate. We assumed 2 per cent growth. You might say that it will be higher or lower, and some issues have been raised about the reform of real estate taxation and financial sector taxation that I completely agree with. A lot could be done with such taxes.

On 2 per cent GDP growth, most people assume a decline in the revenues that will come from the North Sea, as the resource there is finite. Given that overall GDP growth, the non-oil part will probably have to grow faster. The assumption of 2 per cent is made despite pretty aggressive fiscal tightening. We could argue that that might weaken growth, although we have assumed that it does not. Is a 2 per cent growth forecast pessimistic or optimistic? You have to make your own choices, and you have to assume something.

On the issues that Jim Cuthbert raised about the OBR, we have to assume, almost by definition, that something goes back to trend—otherwise, it is not the trend. I have a degree of sympathy with regard to black swan events. There is an interesting—and fair—question about how to communicate risks effectively. In our approach to discussing different currency arrangements, we try to make one point, which is that you have to consider the risks. You should not just think about the good days; you should think about what happens on the bad days, see what the situation might be and back it up by asking what the best currency arrangement is.

I completely agree with the remarks that have been made about black swan events and the risk management approach—that is the right way to do it. However, there is a challenge around how that should be presented. The point is correct.

Gavin Brown: On the narrow point about the OBR's oil projections, would it be fair to say that, for 2012-13 and 2013-14, the OBR's projections have been more accurate than the four Scottish Government projections?

Jo Armstrong: Yes. The OBR would rightly say that the Scottish Government's forecasting track record is not good. Like DECC, the Scottish Government has consistently overestimated when starting the process. DECC, like Oil & Gas UK, has consistently been optimistic on production.

I worked in the industry a long time ago, when the oil price was $100. It collapsed to $10, and I stopped forecasting oil prices. They are notoriously difficult to forecast. The OBR's projections could well be perceived as being pessimistic, but they are realistic, and they have been extremely optimistic in the past.

Margaret Cuthbert: On the OBR's projections, it is important to realise that the oil figures that we have been getting of late have been very much affected by the maintenance and investment that have been going on. The profit figures and therefore the taxes that have come in were very much affected by those. That is not to say that that is any basis for how one would proceed in the future.

Jo Armstrong: Projections take account of the upturn arising from the steadying of production levels, which arises as a consequence of the investments that are currently taking place. They take account of the impact and benefits of the investments that are being made in the North Sea.

Gavin Brown: I would like Jo Armstrong to expand on a statement in her paper. This is on page 11 in our papers—it is from your paper on

"Scotland ... assuming ... a low, or zero, share of the UK's existing debt".

At the bottom of the first page, you say that there is an argument for assuming a zero share as

"Quid pro quo for Scotland not being allowed to share a formal monetary and currency union with the RoUK ... This is the Scottish Government's current rationale for potentially assuming zero UK debt. However, the argument is flawed".

Your paragraph continues. Can you explain why that argument—to assume a zero debt share as quid pro quo for not entering into a formal currency union—is flawed?

Jo Armstrong: The Scottish Government has argued that if we do not have a formal monetary union it is fair to walk away from our share of the debt, but that assumes that we will not get the benefits of the assets of the Bank of England. We are saying that the Bank of England is not the asset; the Bank of England's credibility, track record, treasury and support are the asset. That does not have a monetary value attached to it.

Dr Angus Armstrong: On monetary values, if you treated the Bank of England as any other asset, its net worth—the assets minus the liabilities—is £3.35 trillion, so a population share of that is about £280 billion. That is a lot of money, but that is not the game changer. The game changer is you doing the business in future—it is not the £280 billion.

What do I mean by doing the business in future? The bits of paper that the Bank of England issues used to be backed by gold. Now, they are just backed by a promise, which is a promise to pay. It is a promise on the people who are represented by the Parliament of that institution—in other words, UK taxpayers. Most people would see it as an unreasonable proposition that an independent country—Scotland or any other—would automatically have claim on the taxpayers of another country as a matter of course of business.

Jo Armstrong: Just to clarify: I meant to say that sterling is not the asset; the Bank of England is the asset.

Margaret Cuthbert: That argument is absolutely fair. I cannot see that that could be used as a bargaining chip in that way, as it has been expressed in the white paper. However, it is still not right. Scotland could, if it so chose, do considerable damage to sterling. As Angus Armstrong just said, it is not about the value of the assets in the Bank of England or anything like that. It is about the damage that could be done if the UK Government decided that it would not allow Scotland into its monetary union. At that point Scotland would have oil, which for a long time has boosted the UK's finances.

I still disagree on the future of North Sea oil finances with Jo Armstrong and the OBR, which in its very conservative way brought it into future projections. As I said, DECC has already said that it used very conservative projections on the way forward.

We could do more damage to the UK's finances and the standing of sterling than is allowed for in these comments.

Jim Cuthbert: It is a bit of a red herring to talk about the Bank of England per se. We are talking about individual economies' taxpaying capacity and robustness, and the UK without Scotland would not be in a good position. It would be highly dependent on a grossly oversized financial sector, with international competitiveness that has been declining since the second world war and the emergence of a chronic deficit in trade in goods and services, which was propped up in the 1980s by oil revenues and has been propped up latterly by borrowing, in effect.

The underlying taxpaying capacity of the rest of the UK economy is not a good bet, so to talk about the strength and the robustness of the Bank of England—the pillars on the front door and so on—is to miss the point. We have to look at the underlying economy, and in the rest of the UK that is weak.

11:15

Dr Angus Armstrong: On the—

The Convener: Briefly, because time is marching on.

Dr Angus Armstrong: I completely understand—I will be very brief.

On the point that the balance of payment surpluses would be tremendously badly affected, the UK exports about £500 billion-worth each year; it exports about £60 billion-worth to Scotland. Scotland's exports to the rest of the world—which the UK would lose were Scotland to become independent—are about £20 billion. The figure is £531 billion, less the amount of oil that we would have to import. That would be a negative for the balance of payments, but would that be so detrimental? We have a floating exchange rate for a purpose. That is pretty key to a lot of the discussion.

I do not at all doubt the fact that there would be a small balance of payments implication depending on the oil price at the time, but I do not see how the idea that it would somehow be a cataclysmic event for the balance of payments comes from the figures.

Jim Cuthbert: The issue is not so much the change. Losing the Scottish trade surplus would affect the rest of the UK, but it is the UK economy's fundamentals that one has to worry about. The UK economy is not in a sustainable position. As I said, its international assets and liabilities are more than 700 per cent of GDP and they are growing at a compound rate of 8 per cent a year relative to GDP, which means that in nine years that will double. To my mind, it is inconceivable that nine years from now we would have the UK going on with international assets and liabilities at around 1,400 per cent of GDP without something having happened in the interim. There just is not that number of good assets for the UK.

In effect, the UK is operating like a very large bank and it is expanding its balance sheet at around 8 per cent a year relative to GDP and there are not the good assets for it to invest in to enable that process to continue for another eight or nine years. The strong likelihood is that a UK crisis would happen in that period irrespective of whether Scotland goes, but if Scotland goes that likelihood is greatly increased.

Jean Urquhart (Highlands and Islands) (Ind): I will carry on with that theme. Is a change of direction needed in how we manage the United Kingdom's economy? Some of us fear that more of the same is to come and that we will suffer the same consequences in the not-too-distant future if we continue in the way that we are going at the moment.

On the volatility of oil revenues, Angus Armstrong said that the oil would be better managed by a larger country and asked what would happen if something went wrong or there was a big, nasty shock. Did UK plc have a big, nasty shock? Did it deal with that well?

Rather than comparing the Scottish economy with that of its large neighbour, which does not have a great international reputation for its economic practices—some of us seem to be under a bit of illusion on that—those of us who think that an independent Scotland might be better in lots of ways compare it with countries of a similar size and how they manage their economy. What interest is there in looking at Scotland's economy in a different way and not making more of the same comparisons with the UK? That is not what any of us wants for Scotland.

The Convener: Jean, let the witnesses answer the question. Your question will be longer than the answer.

Jean Urquhart: Sorry.

The Convener: I ask Angus to respond.

Dr Angus Armstrong: I will try to be quick.

The UK is a remarkably centralist model—consider the lack of power not only for Scotland, but for the regions of England as well as Wales and Northern Ireland—and it is very hard to see that that makes any sense when we examine other successful countries.

Jim Cuthbert pointed out the size of the assets and liabilities in the financial sector. I agree that we have a large financial sector—by the way, in terms of assets and liabilities, it is larger in Scotland, so be careful what you wish for. Does it look like we have really sorted out financial regulation? Of course not. We have a lot further to go. It is extraordinary how little progress has been made six years after the crisis. I am completely on your side—100 per cent—on that.

In the debate, much is made of inequality. That is not just a rest-of-the UK issue; it is throughout the whole UK. It is extremely corrosive for economic progress.

On immigration, the National Institute of Economic and Social Research is probably the most pro-immigration academic institute in the UK, so I completely accept the point that we seem to be going backwards.

It is exhausting to consider how the UK could do better, so I am not for a moment trying to say that everything is rosy the other side of the border. That is not really the question. The question is what the costs and benefits of Scotland breaking political links with the rest of the UK would be.

On risks, the UK had a very nasty shock. It managed reasonably well, certainly in the first two years. We can always argue that we should have done things better before. That is obvious. However, given that the shock happened, the first two years were not too bad. There are differences of view on what happened after that. My view, and that of the institute in all the modelling work that we have done, is that some of the austerity was unnecessary.

It is important to consider the capacity for countries to do risk management in future, which is where having your own currency is pretty important. In the dark days of 2009—the beginning of the crisis—sterling was falling and the UK Treasury was asking itself what would happen if it continued to fall and how big the problem was, given the other issues. In some ways, having that flexibility was a real benefit at the time.

I could not agree more on comparing an independent Scotland to other countries of similar size. Those countries do not burden themselves by tying themselves to another country's monetary system over which they would most likely have little control. That is kind of what we have been arguing.

Some of those other countries do not start off with the same level of debt, which is exactly why we have been suggesting the debt-for-oil swap. The point is not to do a raid but that, if Scotland were a small, independent country with a much lower level of debt and its own monetary regime—it is pretty hard to argue against this—we could start to ask what kind of prosperous country Scotland could be. We could have a much more positive and progressive discussion than the current, "We want to have this; we won't do this; we will do this. Where do we move?" That is not getting us far.

Jim Cuthbert: Large does not necessarily mean good management. I will give another example from the UK. The UK's real exchange rate among its international competitors since the second world war has not merely declined but also been subject to very marked medium-term variations—larger than that of most other comparable large economies. That is explained to a large extent by political folly and the destabilising influence of the city. However, large does not mean that a country is able to manage its currency stably. That has been extremely damaging to UK industry.

One has to be cautious about reading too much into how well we handled 2008. What happened then was, indeed, a world crisis in which we were heavily implicated, but our ability to respond and get out of it by printing money was predicated on the fact that other countries in the same crisis were printing money at the same time. If another crisis were more home grown and if, for example, America was recovering and raising interest rates, our ability to use the measures that we used in and post-2008 would be extremely limited.

Margaret Cuthbert: One of the big problems that was obvious in 2008 was that the economy was structured too heavily on the financial sector and not enough on manufacturing. Efforts were supposed to be made to improve manufacturing but, in fact, very little of that has happened—if anything, the banking sector is doing extremely well, as far as the level of salaries is concerned. We also have inequality, which is even greater now than it was in 2008 across the different parts of the United Kingdom.

It seems to me that it is extremely difficult for the United Kingdom to change. Its financial sector is dependent on there being a lot of mergers and acquisitions so that Goldman Sachs and so on make their money on them. Therefore, no effort will be made to reduce the number of mergers and acquisitions. Our competition and mergers and acquisitions policies, all of which are related, are geared towards the continuing development and success of the financial sector, which itself is affected by the current massive bubble in asset prices. I do not see any big improvement for the UK. If we want that improvement, we have to do it on our own.

Jo Armstrong: Scotland has a big financial services sector, so the issues relating to London are equally important for Scotland. However, looking forward, I absolutely agree with Jean Urquhart that changes are needed, but they are needed across the UK. It is for politicians to argue about the extent to which that should happen. However, we definitely need a more effective regional policy, to stop the centralisation effect. That brings with it challenges to do with the EU. If we stay in the EU, our ability to change many of the regulatory regimes and the mergers and acquisitions and competition policies will be limited—we have to accept them as a given.

Therefore, we need to consider how we improve our skills base and connectivity, whether it is physical or through the airwaves; we need to consider how we become more competitive so that we can compete internationally; and we need to think through public sector reform, which is absolutely essential. Given the current financial constraint—we are talking more about the magnitude of the fiscal deficit or challenge, rather than just the fact that we have a fiscal challenge—to maintain current levels of spending or to grow them as a consequence of an ageing population or our desire to maintain certain types of public sector policies, we have to find a means of increasing our tax base. That has to happen as a consequence of our being increasingly productive, and our productivity levels are not good. Therefore, we need to find ways of increasing productivity.

Despite the fact that there are lots of issues to be dealt with, none of the debate around the referendum and very little of the debate around austerity is looking at new economic models, whether at UK level or, dare I say it, in Scotland. We need to be more productive and improve competitiveness, but I do not see debate on that taking place anywhere at the moment.

The Convener: Before Jean Urquhart comes back in, I point out that we have been sitting here for two hours now and, uniquely—it has not happened before—two committee members have had to wander off to the bathroom.

Iain Gray: It is a matter of age, Mr Gibson.

The Convener: Given that our witnesses have also been sitting there for a couple of hours—I will not say that there are no spring chickens among the witnesses, because that would be inappropriate—and that Jean Urquhart has another question and Iain Gray and John Mason still want to come in, it might be appropriate to have a break. The witnesses could grab a cup of coffee if they wish. I call a wee halt for a few minutes, after which we will reconvene and finish off the session.

11:29

Meeting suspended.

11:43

On resuming—

The Convener: I hope that everyone feels refreshed. We continue with questions.

Jean Urquhart: It is always difficult when one is looking at only one side of the balance sheet. A number of people have talked about things that might be done, such as reducing defence spending and introducing a land value tax—assuming, of course, that we had full control of taxation in Scotland. Do the witnesses agree that—although we are where we are and I think that Scotland is in a strong negotiating position—the economic state in which Scotland would find herself after independence is about the other side of the balance sheet?

I live in the Highlands, and a landowner neighbour, who is Danish, pays a land tax to the Danish Government on his landholdings in Scotland. We collect no such tax from him. That is interesting. There seem to be endless possibilities for how Scotland might manage the economy to suit Scotland's needs.

The Convener: Is your question directed at a particular witness?

Jean Urquhart: In view of the time, perhaps I can ask just Jo Armstrong and Jim Cuthbert to respond.

Jo Armstrong: There are many ways—it would be a bit over the top to say that there are an infinite number of ways—in which an independent Scotland could establish its tax regime and determine the revenues that it would generate for the spending that it wanted to incur.

I make two points. First, the world that Jean Urquhart is talking about is not the world that we are in; we have to get there and, currently, we have a fiscal deficit. It is not easy to fundamentally change the revenue position—it cannot be done overnight. Therefore, how do we navigate from where we are to where we want to get to?

Secondly, I refer to work that the Institute for Fiscal Studies has done. I think that it was the Mirrlees review that said that for a small open economy—such as Scotland, which could look to adjust and adapt its tax base, better to reflect Scotland's needs and desires—the likelihood is that the tax regime would generate less tax, because the country would probably want to have more mobile capital and investment. A smaller country tends to have a smaller tax base than is the case if it is part of a larger country. People can walk over the border if they do not like the tax rate that they are being charged.

Fundamental change to the tax regime is definitely a possibility, but we should be careful what we wish for, because it will have consequences that do not necessarily give us the answers that we want. The fundamental issue is how we get to the world that we want to get to and what the fiscal outlook for individuals and the implications for the spending commitments that we are making and want to make will be. The more visionary Scotland wants to be, the harder it becomes for it to navigate its way there from what is not necessarily a strong position.

Jim Cuthbert: I agree with Jean Urquhart that it is about how creative we are. If we were independent, it would be essential to be innovative. However, the position is not hopeless. Last year, we produced a paper for the Jimmy Reid Foundation, "Economic Policy Options for an Independent Scotland", in which we outlined a number of things that could be done.

What worries me more is the position in which we will find ourselves if there is a no vote and we do not get the powers. I will be particularly worried if we are funding part of our public spending via the Calman approach and relying on the income tax base. The Calman proposals are an ill-designed set of proposals and we will almost inevitably be forced to have a higher tax rate in Scotland. We would face the prospect of, in the long run, relative decline and deflation in the Scottish economy. That is the prospect that terrifies me. We would not have the option to adopt the innovative approach to tax that Margaret has talked about and might want to say more about.

Margaret Cuthbert: There is tremendous room for improvement in a separate Scotland. For example, the employment rate among people who live in poor areas is shockingly low. In the 15 per cent most deprived areas, the employment rate is only 53 per cent. The rate in Britain as a whole—and in the rest of Scotland—is well over 70 per cent. There is slack in the Scottish economy and people are deprived of opportunities. That is just one of many figures that show how poorly we are doing in some ares.

As we consider the future, we will not be concerned only with taxes. If we bring all those people into the economy, our tax base will become more secure and we will be able to improve our position. I expect the tax base to improve, which is important.

I talked about the kinds of taxes that we might use. I mentioned land tax, licensing and tax on whisky.

An issue that faces the public sector is the private finance initiative. I am not a lawyer but it is very likely that we might not be able to unpick some of our horrendous PFI contracts. However, every PFI contract contains a projection of how much corporation tax the company will be expected to pay over the life of the project, and it would be a not-impossible exercise to work out what they are actually paying and to demand a rebate on the basis that they delivered a wrongful set of figures in the first place and, in most cases, had no intention of ever paying the tax.

Iain Gray: Given the time, convener, I want to ask three questions to clarify points that have already been made. Two of them are specifically for Jim and Margaret Cuthbert.

First, when we discussed the Scottish economy's capacity to provide for an oil fund, there was, I think, general agreement that, as things stand and setting history aside, there are not spare, free oil revenues that could be used to set up an oil fund, and I asked a supplementary question about what the white paper says on the subject. It says that the stabilisation of the oil fund would come from borrowing on the money markets, but in his response Jim Cuthbert said that that assumed no change to the licensing and tax regime and that a different regime would free up revenues from oil and gas that could be used to set up the oil fund. Is he saying that in his view an independent Scotland should increase the tax and other fiscal takes from the oil and gas industry to create an oil fund?

Jim Cuthbert: No, I did not say that tax should be increased. I said that the percentage of oil-related activity in Scotland could be increased through licensing arrangements and potential tweaks to the tax system and that the multiplier effects of such a move on Scotland's general economy would increase the take via income tax and so on. I did not say that Scotland must or should increase the tax rate on oil.

Iain Gray: Maybe I am being stupid, but I just do not follow that. Either there are more revenues to Government from oil and gas or there are not. Surely activity will depend on what is agreed on the basis of geographical or population share, but all effort will be put into ensuring that we extract the maximum possible from reserves. Is that not right?

Jim Cuthbert: One would obviously want a sensible taxation regime that maximised the level of oil-related investment and the number of fields that were exploited. However, it is important that as much as is reasonably possible of the economic activity associated with oil extraction occurs in Scotland. As I have said, we have 80 per cent of hydrocarbon production but only 45 per cent of the jobs.

Iain Gray: Ah, right—I see the point.

Jim Cuthbert: This is something that Norway managed to do quite successfully.

Margaret Cuthbert: At the moment, labour wages and taxes stay in the UK but another £20 billion leaves Scotland entirely in the form of profits. If it is at all possible, we would want, as Ireland has done in other industries, to encourage more research and development in Scotland and to ensure that much more high-quality productivity associated with that happens in this country.

Iain Gray: As Norway has done by maintaining a majority stake in its oil company. We are back to changing history.

Margaret Cuthbert: Or other oil fields might be discovered in future.

Iain Gray: Okay.

Margaret Cuthbert referred to the balance of the UK economy and the fact that it was overdependent on the financial sector. Not long before that, Jim Cuthbert said something quite similar. He suggested that we should not work on the assumption that the UK economy is risk free and is strong and secure, and said that the UK is "highly dependent on a grossly oversized financial sector."

I might agree with that, but from memory I believe—although I do not know the figure for sure—that the assets of the financial services sector in the UK amount to approximately 480 per cent of GDP.

Jim Cuthbert: No. I can give you the figure.

Iain Gray: Okay—let me finish the point. For Scotland, the figure is 1,250 per cent, which is significantly higher.

Jim Cuthbert: In fact, I was looking at the figure this morning in preparation for the meeting. The assets and liabilities of the UK financial sector are approximately 1,400 per cent of UK GDP.

Iain Gray: And ours in Scotland is 1,250 per cent.

Jim Cuthbert: That figure is disputed. I cannot comment authoritatively on it because I have not looked at the figure, but it depends on how one counts the various parts of Royal Bank of Scotland, Lloyds and so on.

Iain Gray: So your clarification is that, in your view, Scotland is less exposed to its financial services sector than the UK is. Do the other panellists think that that is true?

Dr Angus Armstrong: Having assets as a very high percentage of GDP is a good thing—we want to have those. It is the liabilities that are the bad thing, just to be clear.

Jim Cuthbert: It depends on the nature of them.

Dr Angus Armstrong: Well, if there are any assets—give me an asset and I will be grateful, quite frankly.

Jim Cuthbert: All right: copper.

Dr Angus Armstrong: Anything. Assets are good; liabilities, on the whole, are problematic, depending on what they are used for. The question rests on the level of liabilities as a share of GDP. You cannot add the assets and liabilities together.

I accept completely that there are a lot of questions about how some of the figures are estimated. The figures that are needed to understand which part of RBS's assets should count, and so on, are not publicly available, so that is very hard to do. I have looked through RBS's annual report and public accounts, and it is very hard to find out what its assets and liabilities are in various countries around the world, given the different parts of the bank, the different subsidiaries and so forth. It is a very difficult question.

I take no liability for the published figures, but the figure that the Treasury has published for Scotland is 1,250 per cent bank assets, or liabilities, to GDP. The two sides of the balance sheet balance; one does not just add them together. I do not know whether that number is right as it is very hard to work out exactly, but it is probably a big number and not a low number.

I think that people say that the figure for the UK is 400 per cent, but I am happy to stand corrected. On current measures, most people estimate that bank assets or liabilities probably comprise a higher share in Scotland than in the rest of the UK, but the number becomes very tricky to get at when one starts considering the different legal entities of RBS and things like that.

A much better measure is the contribution of the financial sector to GDP and to employment, as those figures are a bit more robust. In the UK, the sector's contribution is approximately 14.5 per cent of GDP, and in Scotland it is about 13 per cent. The contribution to employment is a bit higher in the rest of the UK than it is in Scotland, but the figures are not a million miles apart.

The message to take from that, given the different ways of measuring the size of the financial sector, is that the extent of the exposure to the financial sector north and south of the border is a big number. That is what I would conclude. On the question of whose exposure is bigger or smaller, that depends on what dimension is used.

The Convener: Jo Armstrong can come in next, followed by Jim Cuthbert.

Jo Armstrong: I am not going to argue a case for which is the right number; they are both large and both significant. The fact that Scotland has a relatively less diverse economic base makes it that bit more difficult to manage. If one does not include the figures, following the argument that RBS will leave Scotland and will be regulated by the Bank of England and the UK regulatory regime, what happens to Scotland's tax base and the assumptions that we are making in terms of corporation tax revenue?

There is quite a lot to be unpacked in all of that. It is a big issue, and it is not something that we can wish away or that will disappear overnight or be dealt with quickly.

The Convener: I do not think that RBS is going to leave Scotland.

Iain Gray: Sorry, convener—I think that Jo Armstrong is referring to the argument in Professor Young's paper and from Standard & Poor's.

Jo Armstrong: Correct.

12:00

Jim Cuthbert: I think that you have to look beyond the banking sector to the financial sector as a whole, as a lot of the dodgy stuff that goes on is in the shadow banking sector and places like that. The whole financial sector is quoted as being 1,400 per cent of the UK's GDP.

I do not think that you can take the view that assets are necessarily good things. I do not have the figure, but an amazing percentage of the pile of assets and liabilities of the UK financial sector as a whole are related to financial derivatives, which appear on both sides—as both assets and liabilities. In the UK—although maybe not in Scotland—in the financial sector there is what is called an internal balance sheet, which amounts to a huge pile of cards that has been built up whereby the institutions owe each other claims in financial derivatives. That is the sort of thing that can go horribly wrong all of a sudden.

The position is potentially even worse than that because, when an institution has a financial derivative, what is measured in the accounts is how much it would have to pay to be relieved of its liability under that derivative. However, underlying that net figure there is a notional asset and liability that could be many times larger. Therefore, if you were to measure financial derivatives "properly" in terms of the notional, implicit underlying assets and liabilities, the figure for the size of the financial sector in the UK would be very much larger than 1,400 per cent of GDP—but nobody knows how much larger. Frankly, nobody has got to grips with the risks or even the proper measurement of the financial sector in the UK.

Iain Gray: I have one last question. Gavin Brown has asked it already, but I felt that the answer that he received went off at a tangent a little bit. Forgive me for asking the same question again.

It seems to me that the core of the discussion this morning has been about assets versus liabilities and what the basis for the negotiation of Scotland's share of debt would be following a yes vote. We have heard about the possibility of swaps of oil for debt and the possibility of compensation for the lack of an oil fund and the 1979 referendum result. I am sure that there are many other grievances from history that we could find to seek compensation for. However, the truth is that the Scottish Government's position is straightforward. It says that monetary union in sterling is the asset that it wants and that, if it does not get it, it will walk away from the debt liability. It said that again this morning, in the press.

Can we be clear that none of the panelists believes that it is correct to set sterling as an asset against our debt liability?

Dr Angus Armstrong: The position that you have described is that if there is not a monetary union with the rest of the UK, as has been set out in the white paper, the Scottish Government's response will be to walk away from any obligations on the debt.

Iain Gray: Because, at that point, Scotland would not have a share of the asset—that is an important point.

Dr Angus Armstrong: Because Scotland would not have a share of—

Iain Gray: Sterling as an asset. That is the Scottish Government's position. Jo Armstrong has addressed that directly in her written submission.

Dr Angus Armstrong: I was trying to reword the question. What do you mean by "sterling"? A population share of the outstanding sterling is not very much money and I do not think that anybody would have an issue with that.

Iain Gray: I mean a share of sterling in a formal currency union.

Dr Angus Armstrong: If you took out the notes and coins called sterling and said that Scotland should have a population share of that money, I really do not think that anyone would have a problem with that. In fact, most of the Scottish notes and coins that are issued—

Iain Gray: But that is not what is meant.

Dr Angus Armstrong: This is why using the word "sterling" is playing with words. Monetary union is about the shared, common use of the central bank. The sterling bit—the notes and coins—is a very small part of that central bank. The two issues get conflated, which is why I am trying to be careful in answering your question.

Would an independent Scotland have a reasonable claim to a population share of the outstanding sterling liabilities—the notes and coins that are out there? Absolutely, yes. Would an independent Scotland have a reasonable claim to a right to a population share of the Bank of England on an on-going basis? I struggle to see how that would be a right, as it is a right of UK taxpayers.

Although, technically, it would not be a default, in my view to walk away from what most people, including the Scottish Government, have suggested is the responsible position of taking a fair and equitable share of the debt would be erroneous. I actually think that it would be an irresponsible position, as I have said before, and it would probably have quite interesting consequences in terms of how other countries, credit rating agencies and foreign investors would perceive it.

Margaret Cuthbert: The fundamental position that I think the Scottish Government should take on behalf of the people of Scotland is that a fair and equitable share would be for us to receive compensation. If the United Kingdom Government says no to monetary union, then it would be fair for a political group in Scotland to say, "The gloves are coming off and we will use whatever powers we have."

Iain Gray: I understand that, but that does not answer my question. My question was this: do you believe that currency is an asset that you can set against debt liability? That is a different question, although I appreciate the position that you have described.

Margaret Cuthbert: I think that currency is an asset. I said earlier that it is an asset in the sense that either side can damage it tremendously. Scotland has the ability to damage the currency, and the United Kingdom Government has not taken that into account in its position, although it is beholden to do so.

Iain Gray: So you think that currency is an asset.

Margaret Cuthbert: Currency is an asset. To look at it the other way, we do not at the minute have a separate currency. If we went for a separate currency right now, you would probably argue with me that it is not as good as the currency of the United Kingdom. Therefore, it would have a value, because you would have made a value judgment in your mind about the two separate currencies.

Iain Gray: Okay.

Jim Cuthbert: I do not think that one can reduce this to a formula. I make no secret of my position, which is that in the long term I would like to see an independent Scottish currency. However, in the short term, there would be negotiations in which everything would be on the table. As I said before, my view is that the white paper's initial negotiating position on debt is mistaken when it states that we would make a very reasonable offer on debt if we got fair play in other respects. I think that that is now off the table, although it might come back. However, we would be embarking on negotiations that would have no formula and which would depend on a lot of things, including the power on both sides of the negotiation. The power of the Scottish negotiators in such negotiations would be very considerable.

The Convener: Do you want to comment on that, Jo?

Jo Armstrong: All that I want to say is that the value of sterling lies in the Bank of England and its reputation of paying its debts, which it has done since its inception. So, that is the value of sterling. I do not think that a Scottish Government of any nature can assume as a given that it will continue to have a call on that. Currently, the position of the members of the UK coalition Government is that that is not on the table.

Jim Cuthbert: Can I just make a comment on that? I think that the appeal to history can be misleading, because the value of sterling historically was based on the navy, the empire and Britain being the foremost industrial power in the world, in which Scotland played a full part. Those are not there now, so the value of sterling is not as great as it was. To regard it as being this great thing that is out there now is nonsensical.

The Convener: Yes. Professor Young has said that there are

> "only two explanations for this stance by the UK Government, which has shaped the current debate on Scotland's currency: either confused logic and inadequate economics, or a subterfuge to frighten Scottish citizens to vote against independence by raising the spectre of economic chaos immediately afterwards."

John Mason: I want to continue with the theme of the reputation or the value of sterling.

Professor Armstrong, in your submission, you say:

> "it is the reputation of sterling, or to be more precise the reputation of the government and central bank that lie behind it, that is of value."

Is it not also the case—certainly from a Scottish point of view—that the convenience of using sterling is an asset? If we did not have sterling, there would be exchange costs, for example, and the banks would make more profits. Scotland having sterling is a bit convenient for England, too, even if it is not as big an issue for England as it is for Scotland. Is there a value in that?

Jo Armstrong: Yes. If there was dollarisation, that would not be an issue for the rest of the UK. If Scotland had a separate currency, that would be an issue for the UK.

Margaret Cuthbert has mentioned the possibility of Scotland not getting what it wants and the reputational damage that could occur. To my mind, that is what was alluded to in the Sir Nicholas Macpherson letter, not the issue of transaction costs. No one would disagree that transaction costs are an issue—they are—but the Macpherson letter refers to the fact that a country that did not want to make monetary union work and be permanent would cause problems for the bigger country, which in this case would be the rest of the UK. That is why formal monetary union appears to have been taken off the table.

John Mason: On other countries' perceptions, my assumption would be that if an amicable agreement was reached—whatever that agreement was—other countries would be happy with that. In other words, there would not be a difference in perception if an amicable agreement were reached between the two parties. In addition, I assume that the less debt Scotland has, the better other countries' and the world banking system's perception will be. Is that correct?

Jo Armstrong: If an independent Scotland starts off with a low level of debt, that will make it easier to argue that it has a fiscally sustainable economic backcloth.

For me, the issue is that if two separate countries are established whose aim is to have different fiscal outlooks—two different tax regimes—the stability and sustainability of the monetary union that is put in place is called into question. If Scotland had to rely on the Bank of England or the UK Treasury to sign off its fiscal policies and it did not allow it to do the things that it wanted to do, that is where the inherent tension would lie. Again, that is the Macpherson line. That is not to say that there would not be a desire to make things work on day 1, but if the automatic assumption is that the two countries will have a different outlook on life, that will create tensions in the future. Given that we know that that tension is there, the view is let us not start down that track.

John Mason: I might come back to that with the other witnesses.

Would the other witnesses care to comment on other countries' perceptions of Scotland in the event that we came to an agreement with the rest of the UK on how to split up assets and liabilities? If that were the case, would other countries' perceptions be perfectly okay? Does anyone disagree?

Dr Angus Armstrong: I agree with you. I think that, if the rest of the UK and the Scottish Government said that negotiations had been held amicably and that they both fully agreed with the conclusions of them, that would put both countries in a very positive position.

Jim Cuthbert: I would like to attach a caveat—that would depend on the underlying deal being sound. If one side were taken for a mug in the negotiations, it would not be regarded as a sound agreement.

John Mason: Right. By that logic, if Scotland secured a very clever deal, we would go up in people's estimation.

Jim Cuthbert: Markets are hard headed. They would probably look kindly on a resource-rich country with low debt.

John Mason: Is there agreement on how much fiscal agreement and how much similarity there has to be for a monetary union to be proceeded with? I understood that Belgium and Luxembourg had a currency union for quite a long time, under which it was still possible for them to allow taxes to vary a bit. In the United States, there is quite a variation between the rates in different states. In a monetary union, is it the case that a certain amount of flexibility is possible? Is it simply the case that there cannot be total flexibility?

Jim Cuthbert: It is.

Margaret Cuthbert: At the time when we were considering whether Scotland should join the euro—there was quite a degree of interest in that idea—our view was that that was quite a dangerous proposal, because, with the monetary union that was being determined, there was not enough flexibility in fiscal policy to compensate if a country's productivity or the hand that it had been dealt meant that a gap opened up between it and the other countries. To us, monetary policy is really important, as is having some leeway with monetary policy.

12:15

Like Jim, I feel that monetary union with the UK is not a good idea, in the long run. Even in the 1990s, when Eddie George came up to Newcastle and was asked what he was doing about unemployment, his stance was that the way in which the Bank of England was governed, and therefore how interest rates were determined, was a function of what was happening to inflation. It is only recently that Mark Carney has said that he would take employment into consideration as well.

John Mason: Is that not the problem with the United States? There are 50-odd states with different tax rates and unemployment problems—

Margaret Cuthbert: Absolutely. The important factors with regard to what is happening in the United States are, first, what is happening in pork-barrel politics and, secondly, what is happening with migration. For example, in the 1990s, there was a huge movement of around 500,000 folk out of Texas.

The United States allows for and accepts tremendous labour mobility. We might find that a bit disturbing, because our culture is different.

John Mason: But the dollar does, basically, work in the United States.

Jim Cuthbert: Yes, but there is so much going for it. The United States is the world superpower. In normal times, it has a surplus. It has wealth that it can fling at pork-barrel politics issues in order to smooth the operation of the union. Further, as Margaret said, it is willing to tolerate, on occasion, levels of internal migration that would be quite difficult in a more settled, European-type country.

John Mason: Dr Armstrong, do you want to comment?

Dr Angus Armstrong: Yes. I find some of what has been said surprising.

I think that your question was about monetary union and fiscal controls. We are dealing with a lot of unions. There is political union, which concerns the issue of sovereignty, and there is monetary union, currency union, fiscal union and so on. Very importantly, there is the issue of economic union. The question is, does political union have primacy? Do the other unions require that in order to work? Page 111 of the white paper says—100 per cent correctly—that, in the future, it would be up to the people of Scotland to decide whether the monetary union or another currency arrangement was in their interests. That is correct. Sovereignty means that people have that choice. So, the other side then needs to agree to an agreement that, it is acknowledged, can be walked away from in the future—that is what breaking the political union, or sovereignty, implies. Therefore, political union is a pretty big part of the issue. The whole point of having fiscal constraints is to try to put that thing back together again and tie all the parties into a situation in which they behave as if there were a political union.

John Mason: Yes, but it seems to me that, from other examples in the world, there is a bit of room for flexibility.

Dr Angus Armstrong: The Benelux example that you came up with is a great example of a situation in which there were no fiscal constraints. Luxembourg is extremely small, compared with Belgium, so there was a really big imbalance that meant that Luxembourg had no effective say in monetary policy in the region. From what people say, it could not win votes, because there was only one of it. No fiscal limits were put on Luxembourg. If it went bust, that would be Luxembourg's problem. Why would Belgium want to control that little country? It would just cloud perceptions. There was plenty of flexibility in that case.

John Mason: And did it work?

Dr Angus Armstrong: It survived for a long time, and the people in Luxembourg were very happy. There is only one place in the world that has bigger banking liabilities in terms of GDP than the UK, and it is Luxembourg, where the figure is 2,000 per cent. It is a particularly interesting case in that regard.

That is an example of a very small country basically tying itself to a multiple times bigger country and accepting its lack of control of those issues. Would tying itself into sterling be the solution that people would want for an independent Scotland, even if it had one seat on the monetary policy committee? Let us just suppose that Scotland had one person representing it on that committee. I presume that we do not expect the other members to behave neutrally—they would represent the rest of the UK. There would be an eight to one majority in each vote, so there would probably not be a great deal of power in setting monetary policy.

On fiscal controls, it is not at all obvious that we even need them. If Scotland wants to do something, that is up to it. One interesting thing about the United States is that many states have non-borrowing statutes—written statutes that say that they will not borrow. They did that themselves—it was not enforced by the centre—because they understand the importance of fiscal responsibility. My bet is that, if an independent Scotland were to go down this route, it might want to, in its own right, take the approach of offering its self-discipline to the markets.

The key is whether the discipline is forced on countries, as has been tried in Europe, or whether the emphasis is put on them and they are told, "We're not bailing you out so, if you go bust, that is your problem." In that case, it is for the country to put fiscal constraints on itself and for it to start behaving responsibly. The United States has a political union that allows it to have a monetary union. Everything else is, in effect, devolved—not quite, but a very large amount is devolved—and that model seems to work very successfully there.

John Mason: That is helpful. Your written submission also states:

> "More indebted countries prefer higher inflation so an increase in debt in one member country will cause the monetary authority to loosen policy across the union."

We have seen that historically or, at least, in my lifetime. There was high inflation, so debts got devalued, which for some people was a good thing. Is it a risk for the UK that a future UK Government, with or without Scotland, would be tempted to encourage inflation to get the debt down?

Dr Angus Armstrong: That is a particular argument about monetary unions. For example, the eurozone used to have the stability and growth pact and now has the euro pact, which is even tougher, because it requires Governments to put balanced budget requirements into national laws. What is being put in place now is extremely tough. The point of that is that when a national Government is choosing the size of its deficit and the amount of debt, if it can have a bit of inflation to erode the real value of those, that is good for that Government. Now, guess what, that Government gets to go to the ECB and vote on inflation, although it has only one vote. The trouble is that the higher inflation in that country is an externality on the next country, so we start to get externalities or knock-on effects on other countries. The whole point of the eurozone is that, to have a stable currency, you need stable Government finances and, to have stable Government finances, you need responsible Government finances. To try to enforce that in the eurozone, tough fiscal constraints have been put on countries. That is because they all have a vote on the ECB.

In the case of the UK, if an independent Scotland had one vote on the monetary policy committee—in which case it would be very hard to see how it would influence monetary policy decisions—the logic of putting constraints on another country goes away. That situation would be much more about what an independent Scotland would like to do, in terms of its constraints. That is an argument against having fiscal constraints on an independent Scotland.

John Mason: If we look at it the other way and assume that there is a no vote and that Scotland does not become independent, are you saying that the UK has no constraints on it at the moment? Given that it looks as though the debt will continue for a long time, there will be a pressure or temptation for future UK Governments to have inflation.

Dr Angus Armstrong: There is a trade-off—that is the key. The pay-off for creating higher inflation is that it reduces the real value of outstanding debts, but the damaging thing is that it reduces real income, so there is a trade-off. One political unit can make that decision, given the best interests of the whole of that political unit. When a national Government sets its debt limit but votes on a whole region's monetary policy, including other sovereign states, that is a different thing, because it can affect the outcomes for those other countries.

The point of political union is to align the debt decision with the inflation decision, so that everybody votes on the same thing—the same debt and the same inflation. Then, the incentives are all correctly aligned. Once they start to be put in different places, there is a much more complex question; in some circumstances, the case can be made for having constraints and in other circumstances it cannot. The question is complex; we are publishing a paper about it next week, so hopefully that will be clearer than my explanation.

John Mason: I look forward to that. That is helpful.

I move on to quantitative easing, on which there seems to be a bit of disagreement. I am not sure that I have quite got my head around that question. On the one hand, the argument seems to be that the £375 billion is just like normal debt and it is just owed to somebody outside the public sector—it is just to be treated in the same way as all the rest of the debt. The other argument seems to be that it is more of an internal adjustment and that it should not be treated like all the other debt. Mr Cuthbert, why do you argue that it is not like another debt?

Jim Cuthbert: There are at least two different levels. At one level, there is the interest paid on that debt. The UK Government is not paying interest on that debt at present—or it is, but the money is recycling back immediately through the Bank of England to the Treasury. It is a form of debt that is not actually costing the UK Government anything.

When, in GERS, Scotland is attributed almost £1 billion for the debt interest on quantitatively eased debt, I argue that that is overstating Scotland's fiscal deficit.

John Mason: Let me pin you down on that. No interest is being paid outside the system. It is staying within the system.

Jim Cuthbert: That is right.

John Mason: That is because nobody outside holds any of the debts.

Jim Cuthbert: George Osborne wrote to the governor of the Bank of England and asked for the interest back on the quantitatively eased debt, and nabbed it back. That is one important issue around Scotland's immediate fiscal deficit as expressed in GERS and the implications of rolling that forward.

To my mind, what is much more important is the question whether the theory will apply. The theory is that, once the economy starts to recover, those certificates will be taken out of the drawer in the Bank of England in which they reside and sold back into the market, and that they will suck liquidity out of the system by sucking out the money that was printed and used to buy those things in the first place.

We argue that there are now serious doubts about whether that process will ever be undertaken, and I have given quotes from a very serious financial commentator, who says that the Government has effectively destroyed a third of its debt because it will never reverse quantitative easing. It will just sit in a drawer forever, with the maturity adjusted to be like war loans and go on forever.

John Mason: The war loan was owed to real people.

Jim Cuthbert: It was, but it was different because interest was paid on it. It was owed to real people but it was never going to be repaid and the burden of interest on it became trivial because of inflation. Quantitative easing is even worse, because no interest is paid on it. It is just a bit of paper on which no interest is paid, and which might or might not at some stage be taken out of its drawer in the Bank of England and sold back into the market.

Other people—not us—are questioning whether that will ever be done. In effect, the Government has got away with that process. Confidence has not been destroyed and the process has been managed, so why should it ever be reversed? If the Government starts to reverse it, it will get into the Haldane difficulty—popping the bond bubble. What happens when interest rates start to rise? If we reverse quantitative easing, there is the danger of a catastrophic rise in interest, the collapse in house prices, the collapse of all zombie firms—

John Mason: I think that I have got the main point.

Dr Armstrong, you do not entirely agree with that. Are you saying that the debt is really outside the public sector, just like other debt?

Dr Angus Armstrong: Correct, although it is not that I do not entirely agree: I totally disagree. I think that what Jim Cuthbert says is wrong and people should be clear that this is not the right way to do it. That is pretty clear.

The liability that was held in the private sector, which is called gilts, has been bought by the asset purchase facility. It is now owned by the asset purchase facility. The replacement asset that is owned in the private sector is called reserves on the Bank of England, so the private sector still owns an asset. The private sector has not been mugged. It had a gilt; now it has a reserve account in the Bank of England.

John Mason: Did the private sector put an extra £375 billion into the UK?

Dr Angus Armstrong: No. The private sector held £375 billion of gilts. It then sold them and gave up that asset in exchange for another nice asset, which is called reserves at the Bank of England.

John Mason: So there is no net increase in the public debt.

12:30

Dr Angus Armstrong: All that happened was a swap of one debt for another. The amount is still owed. I do not know how we could pretend that it is not owed. Perhaps we could just forget the capital.

Jim Cuthbert: No, I—

Dr Angus Armstrong: Can I just finish? One type of debt has been swapped for another.

John Mason: If it is swapped, it is not extra debt, is it?

Dr Angus Armstrong: I did not say that it was extra debt.

John Mason: Right. So when the £375 billion of quantitative easing happened, that did not create extra debt.

Dr Angus Armstrong: No. Some liabilities were bought back and another liability—reserve accounts at the Bank of England—was issued. There were several reasons why that was done in the first place, but one perception was that, if reserves are increased in the banking system, that makes banks more willing to lend money. In other words, the perception was that, if we add to liquidity, that helps banks to lend money. It is not that we created £375 billion of different assets—that was not the idea. The idea was for the banking system to become more liquid, which would encourage banks to lend.

When that did not happen, the motive changed and people said, "Perhaps we are forcing interest rates down." That may or may not have been true. These are difficult things to work out. However, that is not the same as saying that £375 billion of extra assets were sold with no cost. The arguments are about liquidity preference change in the banking system, or an influence on long-term interest rates. That has been the benefit—you have basically taken back one debt and given another.

May I correct something on the point about interest? I think that it was a mistake for the chancellor to ask for the interest payments, and I said so at the time. First, the interest payment is net of the loan from the asset purchase facility to the Bank of England. Secondly, that goes into the public sector accounts, so the public sector borrowing requirement is lower. I think that that is why it was done. It makes the PSBR lower, which means that the Government does not have to issue as much debt. It is not as though the money has been put in the back pocket and is actually a sneaky gain. In my view, it was the wrong way in which to present fiscal accounts, but the money is still within Government. The interest payment is within Government, and the liability was to the private sector. It was £375 billion of gilts and it is now the equivalent level of bank reserves at the Bank of England.

John Mason: We have probably taken that far enough. Maybe I should not have raised it again. I will go away and read about it and try to understand it better.

Dr Angus Armstrong: I am more than happy to write to you.

John Mason: I appreciate both your answers on that point.

Jim Cuthbert: Quantitative easing is usually described as printing money, and the reserve in the Bank of England is essentially cash. In effect, we have printed money and given it to the banks in exchange for some gilt-edged securities. It was presented at the time—

John Mason: Okay. I think that we have heard enough on that topic. You have both given me answers, which I appreciate. Thank you very much. Can I ask—

The Convener: This should be your final question, John.

John Mason: My final question is on the interest rates that Scotland might have to pay. The suggestion is that, to start with, after independence, we might have to pay a higher rate of interest than the UK is paying. However, we see other countries around Europe and elsewhere that are paying lower rates of interest than the UK. Would it be the case that we temporarily had a higher interest rate because people did not know what Scotland was like but, once they got to know that we are just the same as Denmark, Finland, Austria and all those places, our interest rate would probably end up being lower than the UK's?

Margaret Cuthbert: Part of that will be a function of what debt we have. The second thing is that it will be a function of what assets we have. As far as that is concerned, if we retain North Sea oil rather than handing it over to the rest of the UK as a debt swap, we could be in a far better position as far as—

John Mason: Is that purely objective? Is there no subjective element to it?

Margaret Cuthbert: Markets cannot afford to be too subjective after the initial period. There is obviously going to be subjectivity in the first bit, but after that, markets are hard.

Dr Angus Armstrong: It clearly depends on the future decisions that are taken either by the UK or by the rest of the UK and an independent Scotland—of course it does. There is one element that is very hard to reduce, and that is a liquidity premium based on the size of the bond markets. Small countries often have to pay a liquidity premium by the nature of their being smaller. I will give an example. Network Rail's bonds are explicitly backed by the UK Government. We would expect that they trade at exactly the same interest rates as the UK Government, would we not? However, they do not, because the market is much smaller, so it becomes illiquid.

One of the irreducible factors here is that, on the whole, taking everything else out of it, bond markets in smaller countries tend to be smaller and less liquid and a liquidity premium has to be paid.

John Mason: Are you saying that smaller countries generally pay higher rates of interest than bigger countries?

Dr Angus Armstrong: There is a liquidity premium. Many factors determine the interest rate that is paid, including the amount of debt, the deficits and inflation, but one element—it is only one element—is the size of the bond market and the extent to which it is easy to trade in and out of that without affecting prices. Smaller countries tend to have smaller bond markets, and that factor alone tends to argue in favour of higher interest rates. With the other factors, it depends on the decisions that are made.

John Mason: Smaller countries on the whole have stronger economies than bigger countries so they would tend to have lower interest rates, but they pay a little bit extra through the premium that you mention. However, that might not take them up as high as the big countries.

Dr Angus Armstrong: Exactly right. They have to pay the premium, but they could be stronger on every other aspect, with lower debt and better surpluses. Everything else could be positive, so overall they can have lower interest rates because those pluses more than offset the negative of the one factor that I am pointing to.

Based on our assessments, as I said, we came out with the central point about 120 basis points. We have gone through the methodology and repeated it because people have asked a lot of questions about it. We are more than happy to represent the work because we have had some new fiscal figures that should be taken into account.

John Mason: That is great. Thank you.

Jim Cuthbert: I have a quick comment. The Network Rail example is an interesting one. Part of the premium might be because of the utility pricing model, which in effect underpins the financial stream to Network Rail. As that is a flawed model, I take it that there is an element of risk in the bond price that Network Rail attaches to that.

The Convener: Thank you very much. We have exhausted the committee's questions. I am sure that the witnesses are pleased to hear that. Before I wind up, do our guests wish to make any further points? It seems not. Thank you—I really appreciate the time that you have devoted to the committee this morning.

Sadly for the committee, we have not reached the end of our agenda. We will have a 90-second break in order to allow witnesses and the official reporters to leave, because the next section of the meeting will be in private.

12:36

Meeting continued in private until 12:50.

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