The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

FINANCE COMMITTEE

Wednesday 21 May 2014

Session 4

Wednesday 21 May 2014

CONTENTS

FINANCE COMMITTEE
16th 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:

Professor Jeremy Peat (University of Strathclyde)
Professor David Simpson

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The Adam Smith Room (CR5)

Scottish Parliament

Finance Committee

Wednesday 21 May 2014

[The Convener *opened the meeting at 10:00*]

Scotland's Public Finances Post-2014

The Convener (Kenneth Gibson): Good morning everyone and welcome to the 16th meeting in 2014 of the Scottish Parliament's Finance Committee. I remind everyone present to turn off mobile phones and other electronic devices, please.

Before we begin item 1, I want to respond to reports in the media last week regarding the written submission from Dr Qvortrup. Members were notified by the clerks on 7 May that the submission did not address the issues that the committee is considering in relation to Scotland's public finances post-2014. Dr Qvortrup was given the option of providing a further submission, which would address the specific issues regarding the public finances. However, given that the initial submission is not relevant to the committee's current work, Dr Qvortrup's appearance before us would not have added to the discussion.

The Parliament's policy on the treatment of written evidence states that our normal practice is to "publish all relevant evidence." On that basis, the submission has not been published on the committee's web pages. However, it is available from the clerks.

This committee has, in my view, worked on a consensual and constructive basis this session. It is therefore deeply disappointing that concerns were raised directly with the media rather than with me or the clerks, or at the commencement of last week's meeting. Of course, members would have been free to contact the media subsequently—indeed, they were free to do so beforehand, but it would have been more helpful if they had talked to the committee. However, I hope that we can continue to work together constructively and deliver the effective scrutiny that I think is a hallmark of the Finance Committee.

Our first and only item of business today is to take evidence on Scotland's public finances post-2014 from Professors David Simpson and Jeremy Peat. Members have received written submissions from both witnesses, so we will go straight to questions. I am sure that our guests know how we operate on the Finance Committee. I will open the questioning before bringing in committee members.

Professor Simpson and Professor Peat, you should both feel free to add to anything that has been said—and to interact with each other, as that will make for a much more interesting meeting. We will try not to keep you for the three and a half hours for which we kept a previous panel. I am sure that we will have an interesting morning.

Professor Simpson, in the opening paragraph of your submission, you say:

> "The UK Government will assume legal liability for the whole of UK Government Debt following Scottish independence ... it should also assume moral or political responsibility, and ... consequently an independent Scottish Government need not accept liability for a population share of that debt."

You go on to say:

> "Under the 'protective umbrella' of the Union, average living standards in Scotland have fallen in each of the past five years. We have become poorer together."

In your conclusion, you say:

> "If Scotland remains within the Union then its citizens will continue to be saddled with a burden of government debt for decades to come".

I am sure that some members of the committee agree with you; others will disagree. Let us consider the issue in practical terms. The Scottish Government does not intend to go down your line of argument, but if it did so, what would be the impact on an independent Scottish Government's ability to borrow on the markets?

Professor David Simpson: I am not a lawyer, but I suppose that if someone does not have a legal liability, not paying does not constitute default. However, I think that the matter would be negotiable. I would not expect the Scottish Government to pay nothing.

I think that the declared official position is that, on independence, Scotland would assume an equitable share of United Kingdom Government debt. The question is what constitutes an equitable share. I would argue that that is a subjective judgment, and is not quantifiable. My paper was really designed to say why I think that Scottish negotiators should take a fairly hard line on what the size of the equitable share might be.

The Convener: Given that the Scottish Government is looking to have an amicable relationship with the UK over a possible currency union and so on, would it be feasible to deliver the hard line that you are talking about? Is it something that the other side of the argument would be willing even to countenance?

Professor Simpson: I am slightly hard of hearing and I could not quite follow the last couple of sentences.

The Convener: I apologise.

Professor Simpson: No—it is my fault, not yours.

The Convener: Would the UK Government be willing to negotiate with a Scottish Government on the basis of the hard line that you are talking about? Do both sides need to be willing to compromise, even at the outset, if we are to have an amicable arrangement that includes issues such as potential currency sharing?

Professor Simpson: I absolutely agree that there will eventually be an amicable outcome, but that does not mean to say that you start from a position in which you give up everything that you would like to have.

Professor Jeremy Peat (University of Strathclyde): By way of background, let me say that I think that we can all agree that Scotland and the rest of the UK would be far better off if we had made better use of the oil and gas revenue resources in the initial period and had built up a fund in the way that at least one Scandinavian country did. I was fascinated to read in the evidence to a recent meeting of the committee that Gavin McCrone has a yet-to-be-revealed paper in which he recommended the establishment of a fund at the time.

We would be much better off if that fund had been established and if we had not built up public and private debt during the period leading up to and following the recession. Therefore, it is a concern for all involved that the level of debt has reached where it is. However, I very much agree with the gist of your point, convener, which is that the markets would take a pretty dim view of Scotland seeking to reduce substantially its liability for the debt as part of the negotiations.

The UK has the credit rating that it has because it has never defaulted and has never come close to defaulting. Scotland, as a newly independent nation, would have to establish its own credit rating. It would start with, potentially, a somewhat higher cost of borrowing, as Angus Armstrong and others have demonstrated, than is the case at present, and it would wish to achieve credibility so that the cost of borrowing came back towards the UK level as rapidly as possible. Being seen to default or as wishing to default, which is what I think the markets would deem it, would put that passage towards lower borrowing costs at risk and would therefore be counterproductive.

I also agree that there will be a very difficult negotiation over a currency union. As I state in my paper, I believe that a currency union is the best option for Scotland and, potentially, the best for the rest of the UK. I would far prefer to see effort put into achieving that end, even if it involves accepting an appropriate share of the debt, whatever that may be, and appropriate arrangements to reimburse Her Majesty's Government for the borrowing that it has agreed to take responsibility for in the first instance.

The Convener: Why would the markets consider that Scotland has defaulted if the Treasury has legally accepted responsibility for the debt that it has run up over many decades, most of it in recent years?

Professor Peat: My understanding is that the Treasury has taken legal responsibility for the debt in the sense that it will be the party that repays to the markets as and when debt becomes due. However, that is based on the expectation and the firm understanding that the Treasury would, in turn, be reimbursed by Scotland in the event of Scottish independence, on a basis to be agreed between the two countries. Scotland would meet a proportionate share of the cost of servicing that debt, which would then be passed to the Treasury, even if the Treasury had legal responsibility in the first instance.

Professor Simpson: I agree. If the negotiations ended in disharmony and disagreement, the view might be taken that, in some sense, Scotland had not played fair with the rest of the UK. That might or might not have some impact on market sentiment.

However, you have to understand that the question of the Scottish share of the UK debt is just one of many elements in the negotiating pot. For example, when Ireland left in 1922, it negotiated away its entire share of the UK national debt in exchange for moving the border further away from Belfast. The point that has to be made is that it is all negotiable, but when you start a negotiation, you do so by trying to make as strong an argument as you can, rather than by saying, "Okay, we will give you everything that you want."

The Convener: Of course, one or two of our witnesses have said that the Scottish Government's proposed population share of 8.4 per cent of the UK debt might be too modest and that, because Scotland has a greater gross domestic product per head, we should contribute a higher share. I take it that you think that that suggestion should be completely discounted.

Professor Simpson: As I said, once you recognise that it is a moral or political claim rather than a legal one, you recognise that these things are subjective and that different people will hold different views. That is how we get to a negotiating situation.

Professor Peat: My view is that the question whether a population share or a GDP-related share is used is very much one of negotiation and discussion and would be dealt with as part of the overall process. I repeat that what matters is the perception of the markets rather than the firm legal position. If the markets perceive that Scotland is not acting appropriately with regard to taking on a fair and reasonable share of debt, that is what will influence their thinking, rather than the fine detail of the precise legal position.

The Convener: We will now switch to Jeremy Peat's submission—I will jump between the two submissions as we go along, depending on the subject and my whim.

Your submission states that one issue is

"whether the conditions under which a continuing currency union might be agreed permitted sufficient flexibility to Scotland on the fiscal and monetary fronts to develop her own priorities and policies."

Do you think that a currency union would give Scotland more or less flexibility in those areas than it has now?

Professor Peat: I think that the position would probably be roughly the same. If there were to be agreement on a currency union, there would be a requirement—there is a question whether that would be 100 per cent necessary or appropriate in strict economic and financial terms—for monetary policy to remain the province of the monetary policy committee, which would look primarily, if not exclusively, at the interests of the rest of the UK. At the same time, tight and binding fiscal constraints would be imposed on Scotland, in terms of the overall balance between expenditure and revenue. I think that that would inevitably be part of the package.

Whether the monetary policy committee goes beyond that to introduce constraints on individual elements of fiscal policy is significantly more uncertain, but I doubt that it would permit changes in corporation tax, for example, that would be deemed to advantage Scotland over all or parts of the remainder of the UK. Given what has been stated politically thus far, agreeing a currency union would be a tough enough process. The great conundrum is that, although it would be preferable for Scotland to have the stable and fixed rate continue, as that would enable the early days of independence to take place against the background of a stable story, it might come at the price of yielding up flexibility on monetary and fiscal policy and, potentially, on some particular fiscal instruments. That might be difficult for a new Scottish Government to accept.

As ever with these things, there will be trade-offs to make. Would the advantage of stability and continuing exchange rate security be an acceptable trade-off against the loss of the flexibility that could have been achieved in the event of an independent Scotland having its own currency? That is the type of discussion that would have to take place.

The Convener: There are 17 countries in the eurozone at present, and none of them has such tight fiscal rules. Why would there be such a tight level of control between Scotland and RUK, relative to the position in the eurozone, for example?

10:15

Professor Peat: First, there is one interest rate in the eurozone and one monetary policy. Increasingly tight fiscal rules are in place at the aggregate level and there are constraints on individual countries. Ireland has been mentioned, and there are concerns about the corporation tax rate in Ireland and whether that will be acceptable to the European Union. In the EU, therefore, the debate is taking place about rigidity of fiscal policies in aggregate terms and the extent of flexibility that will be permitted to individual member states in terms of individual regimes. The same process and the same debate would apply to Scotland and RUK. I think that it would take quite an effort to encourage the political parties at Westminster to agree to negotiate on the currency union; if that end were to be achieved, they would require fairly significant concessions on the part of the Scottish Government.

Professor Simpson: The only effort that is required to persuade the parties at Westminster to agree is to have a yes vote in September because the salient point about the currency union is that, in the event of a yes vote, it will be the best option for RUK. That is why that apparently anonymous cabinet minister—I think that we all know his name—said that of course there would be a currency union, not because it is in Scotland's interests but because it is in the interests of RUK, as the Scottish market is the second largest market for RUK after the United States. Currency union will be the preferred option in the event of a yes vote for purely hard-headed reasons.

Jeremy Peat is quite right about the restraints on overall monetary and fiscal policy, but he forgot to mention that those restraints would be reciprocal—they would apply equally to Scotland and RUK. That might seem tough for people to swallow, but in the climate that we are entering—which I hint at in my submission—of debt being a perennial spectre at the feast, a number of far-seeing politicians would welcome constraints on fiscal policy because such constraints would give them cover against the clamour of those in their own parties who wished extravagant spending to continue.

The Convener: Following on from my earlier quotation, I note that Jeremy Peat's submission also says:

"a move would appear necessary by Scotland to either enter the euro zone ... or establish a new and distinct Scottish currency".

You argue for currency union for reasons of stability, but then you say that, almost inevitably, we would move on from that position. Do you not think that a lot of assumptions are being made there?

Professor Peat: I agree that a lot of assumptions are being made. I also agree with David Simpson that, almost certainly, the continuing currency union—and it would be a continuing union, as we are in a currency union now—would be the best outcome for RUK as well as for Scotland but, unfortunately, hard-headed logic does not always apply in political discussions.

I am simply saying that if, after a period of independence, the severe constraints on fiscal policy and the constraints on monetary policy were deemed unacceptable, there would have to be a move to an alternative. That might happen because the economies diverged: the Scottish Government could introduce a variety of different policies that took it in a different direction from RUK, or the position on oil and gas revenues could make Scotland susceptible to different forces from those that affected RUK. The monetary policy could become increasingly inappropriate and Scotland could face different fiscal policy issues.

In those circumstances, the Scottish Government might wish to uncouple itself from the currency union in order to develop monetary and fiscal policies that were specific to Scotland and which were in the best interests of Scotland as an independent nation. At that stage, Scotland might be ready to move to its own currency or, if circumstances have changed in Europe, to consider a move to the eurozone.

There is a host of assumptions. I am trying to think forward to whether a currency union, if achieved, would be acceptable to the Scottish Government in the long term, and I suspect that there may be circumstances in which it would not.

The Convener: You have ruled out sterlingisation, which Jo Armstrong touched on when she gave evidence. Will you give us some further detail as to why you are against it? You talked about stability being one of the reasons.

Professor Peat: I am not the greatest expert on sterlingisation or a currency board but, from what I have read and from speaking to people in different parts of the financial sector and elsewhere, I do not believe that it would be seen as a stable and continuing position for a country as substantial as Scotland.

There would be risks that the Scottish financial sector would see that the currency relationship was uncertain and that there were risks of changes. The sector might wish to relocate some of its activities to the rest of the UK, given that many of the companies in it sell many more products in the rest of the UK than they do in Scotland. The markets might not be convinced that the relationship was stable and might charge a premium on interest rates.

I find it unlikely that sterlingisation would be a valid option. John Kay appears to have changed his mind on that, but I believe that it is less than likely to be a viable option and that, in practice, the stark choice will be between a currency union and an independent currency.

The Convener: Do you want to say anything, David?

Professor Simpson: I do not want to add anything to what Jeremy Peat said.

The Convener: Let us return to debt for a minute. Dr Jim Cuthbert talked at some length about quantitative easing and the role that it plays in debt. We already had a brief discussion about what Scotland's share of debt might be post-independence if, indeed, Scotland votes for independence. Should the £375 billion that has been put into the UK economy through quantitative easing be included in that figure? Dr Cuthbert argued that it is not real debt. The Treasury pays no interest on it, for example, because, in effect, it circulates within its own system. What is your view on that? Should any negotiations include or exclude quantitative easing?

Professor Peat: I read Jim Cuthbert's work with considerable interest. It was a novel argument to me but one that I found powerful. If the quantitative easing funds do not cost anything to service and if they end up being written off, that debt involves no cost to the UK Government and I do not see that it would justify any cost to a Scottish Government post-independence. I quite agree with Jim Cuthbert that, if the QE funds are just sitting there, if no interest is falling due and if, in due course, they are written off as part of the process in years to come, it is wholly inappropriate for them to be included and for Scotland to pay for servicing debt that no one else is paying for.

The Convener: David, would you like to say anything?

Professor Simpson: Once more, I do not need to add anything to what Jeremy Peat said.

The Convener: It is good to have some consensus, although I am not sure whether it will continue.

I have a question for you, David. You talk about the recession that we have gone through not being a global one but, in effect, being made in London and Washington by the Blair-Brown and Bush-Cheney Governments. You say:

"the financial crisis that began in"

2007

"was neither external nor global."

Our discussions about finances post-2014 are not only about what happens if Scotland becomes independent. What concerns do you have about the public finances if Scotland remains in the union?

Professor Simpson: I am sorry, I did not catch the last sentence.

The Convener: What concerns do you have about the state of the public finances if Scotland remains in the union?

Professor Simpson: My concerns are expressed in my paper, more or less. We would then be in the same boat as the rest of the United Kingdom, which looks to me as if it is heading for some very rough weather because, in addition to the published explicit debt, there are all the other liabilities that are not taken into account in the published accounts. They include state pension obligations, the public sector worker pension obligations, the increases in future healthcare spending and, indeed, increases in all Government spending that would exceed that which can be paid for by revenues that are raised under the current tax regime. I referred to research by an American economist who puts the numbers very much higher—five times higher—than the accumulated past debt. That is only a very rough estimate, but it still gives us cause for concern.

In practical terms, I think that we will find that, even when the current planned increases in taxation and cuts in public expenditure that have been laid out between now and 2018 are completed, there will be a further need to either increase taxes or cut public expenditure, or do both, simply in order to keep Government debt within limits that are acceptable to the financial markets.

Professor Peat: David Simpson's paper and the question that was asked, to which he has responded, simply underscore the importance of looking at various scenarios for the long-term outlook for the public finances. The committee discussed the Institute for Fiscal Studies figures in one of its sessions. Witnesses and members reinforced the point that they were projections rather than forecasts, but it is very important that we look at the longer term and what the story could be over a period beyond five years. It is important that we look at what will happen to expenditure, given the health and demographic issues, and what is likely to happen to finances under various scenarios, to get a view of the long-term health of the public finances.

One of the Office for Budget Responsibility's roles at the UK level is to produce longer-term forecasts. The IFS also takes that on. Doing that would be as important in an independent Scotland, if not more so, as it is in the UK as a whole because, in an independent Scotland, demographic issues such as the ageing population and the story on health would need to be examined, along with issues around what will happen on the tax side, given the various stories about what will happen with North Sea oil and gas.

There are many uncertainties and different paths that could be taken in the longer term. Examining them and considering the potential implications will enable the Government to get a feel for the risks and uncertainties and therefore to plan the public finances not just by looking at a two-year or three-year period, but by taking account of the longer-term elements. That is critical, and it is important that some of that work is done by independent bodies rather than wholly within the Administration.

The Convener: Do you believe that there are public finance risks and uncertainties regardless of the outcome of the referendum?

Professor Peat: Of course there are—absolutely. However, if Scotland is independent, the public finances will be of even more importance for the management of the economy and the development of economic policies and within the relationship with the markets than is the case for Scotland now. I am not saying that the risks and uncertainties will increase dramatically; I am simply saying that the importance of looking at and understanding them will be enhanced, especially if the Scottish Government wished to change a number of policies, as would no doubt be the case. Understanding how changes in those policies could play out in the longer-term context would be important to help policy formation and make decision making as sound as it can be.

10:30

The Convener: I open up the session to questions from members around the table. Malcolm Chisholm is first, to be followed by Jamie Hepburn.

Malcolm Chisholm (Edinburgh Northern and Leith) (Lab): I mainly want to ask about debt, but since Jeremy Peat raised the question of the currency union I will ask one question about that. I note that both of you say that it is the best option for the rest of the UK although, as you know, distinguished economists who have preceded you at this committee took a different view and all the UK parties take a different view.

In a way, Jeremy Peat gave some of the objections that we know about from the famous, if not notorious, note by Sir Nicholas Macpherson. He said that a currency union would not last and you raised that possibility. He also said that the terms would be unacceptable to the Scottish Government. Shall we say that there is certainly not unanimity around the views that you have expressed?

I am interested in hearing more about your view about the terms that might be demanded. You say that a currency union would be in the interests of the rest of the UK because of transaction costs; I am interested in that, too. Surely if that was the case, the UK would be banging at the door of the euro, which is the exact opposite of what it intends to do. Transaction costs are clearly not the only or even the overriding issue for the UK Government.

Professor Peat: That is certainly the case, and I do not disagree with any of your comments. They enhance the difficulty of the discussion.

The National Institute of Economic and Social Research looked at this issue in its latest paper. For the rest of the UK, the advantages are in the continuity of the relationship. That matters more to Scotland than it does to the rest of the UK, because a higher percentage of Scotland's trade and business relationships are with the rest of the UK than is the converse. For the rest of the UK, as the convener stated, Scotland is the second largest market. So many companies operate across the two countries that continuity of the exchange rate and the removal of any risk of transaction costs or any question of VAT being payable for cross-border trade if certain conditions applied would make it much more comfortable and straightforward for the rest of the UK to continue in the currency union than for Scotland to have an independent currency and for all the currency risks and uncertainties, and the costs, to prevail.

You asked why that would apply to a UK currency union but not to the UK joining the euro. We are talking about the status quo. We are talking about the position that is the case with the rest of the UK and Scotland in a currency union. Moving into the eurozone would mean the UK giving up independence of monetary policy, and the exchange rate would move as appropriate for the whole zone rather than just for the UK. It would also mean that the stability and security of the eurozone was uncertain. I do not think that those arguments have the same weight in the question of the UK entering the eurozone as they do in the case of the benefits that would apply to the rest of the UK from being in a stable relationship with Scotland as part of a currency union.

Professor Simpson: Once again, I am sorry to embarrass or disappoint him, but I agree with everything that Jeremy Peat said. There would be a reduction in transaction costs on trade between the UK and the EU and the rest of the eurozone if the UK were to join the euro, but those benefits would be outweighed by the factors that Jeremy Peat alluded to.

The term "UK currency union" is rather unfortunate because it implies something new, whereas it is the continuation of something that is happening now. In other words, it will be business as usual. That is the main reason for wishing to have a currency union. It just formalises the status quo.

Malcolm Chisholm: I move on to debt, although the question might be academic because, if the Scottish Government refuses to have anything to do with the debt, as Jeremy Peat said, it would have rather a devastating effect on interest rates.

David Simpson says in his submission that there is no moral case for Scotland taking on any responsibility for the debt. I find that view rather astonishing. Do you not think that Scotland has benefited in any way from the spending that has come from the UK Government? I agree that it would have been better to have an oil fund in the 1970s, but that is history. Has Scotland not benefited in more recent times? Let me give two examples. First, in its early years, this Parliament benefited enormously from the public expenditure of the Labour Government that you deplore. Secondly, and more recently, the Scottish banks were bailed out. In fact, the biggest increase in the deficit was in order to bail out the banks. Those benefits undermine your point that we have no moral responsibility in relation to the debt.

Professor Simpson: I hope that I did not give the impression that we had no moral responsibility for any of the debt. If I said that, I apologise. I think—I hope—that I said that we should not accept a moral responsibility for our per capita share of the debt. In other words, that would be the starting point of the RUK negotiators and we should not start the negotiations by accepting that position. The Scottish Government has gone so far as to say that it would accept an equitable share. I am just saying that we ought to be careful about agreeing what that equitable share should be. In our negotiations, we should be very clear about why we might not want to accept a per capita share of the debt.

Professor Peat: In effect, it is inevitable that Scotland would find itself responsible for servicing some of the debt for which the Treasury has taken responsibility, and the extent of debt for which it would be responsible would be part of the negotiation process. Pure economics would not be the only factor; I suspect that the discussions would be as much political as part of an overall bargaining process as anything else.

Malcolm Chisholm: Professor Simpson's paper goes into the history of how the debt was accrued. None of us wants to have too much debt although, in historical terms, the current debt figure is not necessarily such an alarming one. I noticed that the figures go back 150 years. For example, in 1932, the debt was 177 per cent of GDP. Therefore, is it not the overall level of debt that matters?

Professor Simpson made a particular point of attacking the Labour Government, so I must respond to that. In that regard, was the 2007 level of debt before the banking crisis not in fact lower as a percentage of GDP than it was 10 years previously?

Professor Simpson: It might well have been, but the point was that having had a period of growth that ended in 2007, one would have expected the budget deficit to be much lower than it was. In others words, the issue was structural. We moved from a position in 2000 of having a structural budget surplus to a position in 2007 of having a structural budget deficit. That was the period in which the public finances were really mismanaged.

Malcolm Chisholm: I do not know whether you held that view at the time, but no other political parties did—in either this or the other Parliament—because of course rules were being followed. The debt was mainly a result of the build-up of capital expenditure, which in 2007 was three times greater than investment expenditure in 1997 and the current budget deficit was very small. Looking to this Parliament, was there not in fact a great need to have an expansion of public expenditure at the time because of the state of the health service and other public services?

Professor Simpson: In retrospect, one could argue on grounds of need that those expenditures were desirable, but the question is whether they were affordable. The answer is that they would have been affordable had the UK economy continued to grow after 2007 at the rate at which it had grown from 2000 to 2007 but, as we all know, it did not. The lesson is that we cannot just make the optimistic assumption that growth will always be there to provide the revenues that we need to pay for the increasing costs of our public services.

Professor Peat: I agree with that last comment. Going back to 2007 the assumption, and expectation, was that we had secured an environment in which growth around the trend would continue virtually indefinitely and that we had managed the monetary and fiscal policies of our economy in such a way that stability was ensured and 3 per cent growth would continue, which would mean that a structural deficit of that order of magnitude was manageable. Unfortunately, we were complacent and did not allow for the huge build-up of private debt that took place and which, along with the banking crisis, led to such a rapid and deep deterioration in our economy that the public finances, which we can see in retrospect were slightly loose at the time, became severely damaged and we went into the deep and dark days that we all know about.

The combination of the public finances being maybe marginally loose at that period and the deepest recession in economic history in the UK led to the outturn where debt and annual deficit levels were at wholly unacceptable rates. The history is there, and with the benefit of 100 per cent hindsight one would say that there should have been a lower structural deficit; that, if those public expenditures were wanted for good reasons, the finances should have been tightened by tax revenue being raised in different areas; and that the housing boom, credit card borrowing and household debt increases should have been constrained by one means or another, possibly with tighter monetary policy.

We allowed the boom to develop, and the bust inevitably followed. With the benefit of hindsight, one can see all that went wrong. It is easy to look back now and see that, but at the time we believed that we had cracked it, that we knew how to run the economy and that all was going to be sweetness and light for the indefinite future. Sadly, that was wrong, and for me it just reinforces the view that you always need to look at the risk and uncertainties and never assume that everything is secure and stable. You have to look at downsides as well as upsides, and you have to take account of that in policy making.

Malcolm Chisholm: You said "we", but do you accept that it was not just the politicians but the economists, too? Nobody really saw what was coming down the track. Do you also accept that the largest contribution to the deficit was the banking crisis? In that sense, I feel that Professor Simpson's paper is slightly unbalanced.

Professor Simpson: First, I did not see the crisis coming, partly because I was not looking. It was not then—and is not really now—my area of specialism. In fairness, those who saw it coming and said so at the time need to be mentioned. One of them was the Bank for International Settlements in Geneva—a little-regarded bank, but a sort of central bank—which continuously sounded a warning. There were also warnings from the European Central Bank and from our friend Vince Cable, who asked a very pointed question in the House of Commons—I can send you a copy of it if you want—but received a brush-off. There were a few people whose eyes were on these affairs and who were concerned about the unsustainability of the housing boom in the period up to 2007.

I do not agree with the idea that somehow such events just come out of the blue like meteorites from outer space. It is very clear that such events have traceable causes, which are misapprehension about the nature of economic activity and the effects of monetary policy. The phrase, "No return to boom and bust" was often repeated at the time. As I said in my submission, that in turn gave rise to an underprovision within the Treasury for the possibility of a recession, with the consequence that that made things worse. However, the recession did not come from outer space. It was man-made—it was made in Whitehall as well as the City of London, and in Washington as well as Wall Street. That has subsequently been extremely well documented. Anyone who thinks that we live in a world in which there will be no return to boom and bust has simply never read the most elementary books on economic history, which show clearly that a cycle of boom and bust has been a feature of capitalism since at least the middle of the 19th century.

10:45

Jamie Hepburn (Cumbernauld and Kilsyth) (SNP): I will focus on Professor Simpson's submission first. It says:

"Under the 'protective umbrella' of the Union, average living standards in Scotland have fallen in each of the past five years. We have become poorer together."

That begs the question: how much poorer?

The submission also says:

"If Scotland remains within the Union then its citizens will continue to be saddled with a burden of government debt for decades to come".

Is it your position that, if there is a no vote in September, we are likely to continue being poorer together?

Professor Simpson: We touched on the issue a couple of questions ago. The outlook for the UK as a whole is fairly rough over the next several years. I hesitate to say that that will be reflected in an absolute decline in living standards because, as Jeremy Peat will agree, economists have no special view of the future and no insight into what will happen next year. If somebody tells you what the level of the stock market will be one year from now, do not believe them, because they do not know. Equally, economists cannot predict what interest rates will be in one year's time, let alone two, three, four or five years' time. However, from what we know about economic activity, I would say that the prospects are for a much tougher period over the next five to 10 years than we were accustomed to enjoying up to 2007.

Professor Peat: What Professor Simpson says about the difficulty of forecasting is absolutely right. One of my favourite sayings—I think that it was said by Eddie George—is, "There are two types of economists: those who don't know, and those who don't know that they don't know." The latter are dangerous animals. If anyone comes to you with detailed econometric equations, do not believe them—they do not know. We can all hypothesise and try to understand what is going on and how it feeds into the process, but no one has absolute certainty.

On the decline in living standards, GDP has fallen over an extended period. This year, we might get back to the level of GDP that we had pre-recession, but we will not get back to the pre-recession level of GDP per head in the UK for some time longer, because the population has grown considerably, so GDP per head will still be below what it was before the recession.

In his submission, David Simpson says that average wages might get back to pre-recession levels in 2019. Real wages have not moved upwards until perhaps the past month or so, when there has been an increase. The period has been very tough. However, we are now growing at a much stronger rate than we have for a number of years. Whether that is sustainable depends on the view that is taken about whether the increase is balanced or is overdependent on consumption and funded by a combination of positive views about the housing market and payments from banks for their excesses in lending in different ways.

I am not convinced that we are 100 per cent sustainable yet. I worry that we do not have the necessary growth in corporate investment and that the manufacturing and exporting sectors are not back where we would like them to be. We have a way to go before we have the balanced growth that will allow us to relax a little. I hope that we will get back to the pre-recession level of GDP per head next year or whenever and that we will have gentle increases in average earnings rates over the next few years.

My personal view is that, whether Scotland is an independent nation or part of the UK, the five years ahead will be very tough, and very tight policies will be required to progress towards a more stable and sustainable environment. Even when we get there, we will—given the lessons of the past—have to continue to watch out for risks and for unexpected or undesirable events. We must continue to be conservative—with a small "c"—in how we deal with economic policies and public finances.

Jamie Hepburn: In his submission, Professor Simpson discusses revenues from Scottish waters in the North Sea. I will come to that in a minute.

It was interesting to hear Jeremy Peat say that it would have been much better if we had used oil and gas revenues better in the early years. He referred to the report by Gavin McCrone that Professor McCrone revealed to us at the committee. We now know that Gavin McCrone prepared that in advance of the UK Cabinet meeting to which Jim Cuthbert referred when he was here. The minutes of that Cabinet meeting on 15 December 1977 state:

"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."

Jim Cuthbert's perspective was:

"That is, explicitly, why we did not get an oil fund."—[*Official Report, Finance Committee*, 30 April 2014; c 4036.]

Perhaps the witnesses can comment on that.

Professor Simpson, your submission says:

"Despite oil tax revenues from the Scottish waters of the North Sea having contributed some £160 billion to the UK Exchequer since 1980 ... every family in Scotland has ended up with a debt of some £50,000."

You contrast that with Norway, which has

"a sovereign wealth fund that in 2012 was worth some £450 billion, or about £200,000 for each Norwegian family."

To me, that leads to an obvious question—what lessons for the future can we draw from those experiences?

Professor Simpson: Do you want me to say more on that?

Jamie Hepburn: Indeed. That has been our historical experience—it is history, and there is nothing that we can do about what has happened. Surely, however, we can draw lessons for the future from that experience.

Professor Simpson: I hope so. I agree with Jeremy Peat that the future—in particular the next five years—will be exceptionally tight under whatever governance arrangements we have. However, I hope that things will not be so tight as not to leave room for at least the beginning of the establishment of some sort of oil fund.

It is significant that, of all the countries that have had oil as a significant part of their wealth, only the UK and Iraq have failed to establish an oil fund. I hope that it would be an early priority for the Scottish Government to do that.

Professor Peat: I entirely agree that it would have been desirable to establish an oil fund when North Sea oil and gas revenues were booming. That would have been a far better approach. As a nation—the UK and Scotland—we have suffered in relative terms from the failure to take that step. I am not aware of the exact circumstances in which the Cabinet decided on that, but I listened to what Mr Hepburn said with interest.

Over recent years, Scotland has achieved a higher level of public expenditure per head than the average across the UK, while the level of non-oil and gas tax revenues here has been roughly the same as the UK level. I am not sure whether the higher level of public expenditure per head has partly been in compensation for the lack of an oil fund or whether it could be justified on a needs assessment basis. Until we have a full needs assessment and a retrospective study, we will never know. However, one has to remember that Scotland has enjoyed a higher level of public expenditure per head during that period.

The best time for an oil fund was in the past rather than being in the future. I would like us to explore the possibility of planning the public finances in Scotland on the basis of a reasonable central expectation for oil and gas revenues, which it would be preferable to agree with external, non-partisan parties. If actual oil and gas receipts exceeded that reasonable level, the receipts above that level could go into an oil fund. If the receipts were below the expectation, the Government would have to compensate for that from elsewhere in its tax or expenditure plans in order to manage.

That slightly unbalanced approach to managing the public finances as oil and gas revenues varied against expectations would allow an oil fund to begin to be built up. If one had very strong revenues, which some in the Scottish Government expect, I would prefer the revenues that are above the level that most people expect to go into a fund rather than be treated as part of the standard public finances.

That would be my approach. A reasonable central expectation should be obtained and the budget should be run on that basis. If revenue streams were below that level, the Government would have to cope; any revenues above that level should be put into a fund, which could be built up for capital and other expenditure in the years ahead.

Jamie Hepburn: Can we draw from the experience that I described the lesson that we should not rely on a political class that discounts—on a political rather than practical basis—a recommendation to establish an oil fund from one of its senior economic advisers to make such decisions for us? Is that one lesson that we could draw from that experience?

Professor Peat: One lesson that I draw from that experience is that transparency is of great value in aiding good decision making and holding those who make decisions to account. If there had been more transparency—not necessarily from the senior civil servant, but from an external body that looked at the issues rationally, from a position of sound analysis and on an evidence basis—it would have been possible to judge Government decisions against the backcloth of that analysis. Having such information in the public domain would provide some constraint on decision making and help the public to understand and to decide whether they supported decisions that were taken by Governments.

Professor Simpson: I will comment on Jeremy Peat's citation of Scotland having higher public expenditure figures over a number of years. That is frequently referred to but, as everyone must be aware, public expenditure on anything—whether in the public or the private sector—is merely a measure of inputs. What we really need is a measure of outturns or outcomes.

It is fair to say that, over the past 10 years or so, much more attention has been paid in the public sector to outcomes, whether in health, education or other areas, although it is hugely difficult to measure such things. At least we are trying to measure the right things. Until we have succeeded in doing that, I will not be at all impressed by measures of input, because we do not know how much of that input resulted in good outcomes and how much of it was simply wasted.

Professor Peat: Last autumn, in my days at the David Hume Institute, I had a valuable and informative discussion with the committee on the national performance framework. I think that the NPF is a wonderful creation. More emphasis on what David Simpson just described—determining what the desired outcomes are for a Scottish Government and measuring the extent to which they are being achieved across a variety of activities—is extremely important. Scotland should be very proud of the NPF, which should be much better known and much more influential in how decisions are taken.

The Convener: We certainly agree with that.

Jamie Hepburn: Thank you for those answers, gentlemen.

Jeremy Peat's submission says that further fiscal devolution is

"both feasible and desirable if there is a 'no' vote",

but do you acknowledge and accept that there is absolutely no guarantee that that will happen?

11:00

Professor Peat: Yes. I had the great joy of chairing Nicola Sturgeon and the leaders of the four other core parties that are represented at Holyrood at a series of events in January and February. I was quite excited when Willie Rennie announced that he had asked Sir Menzies Campbell to speak with representatives of the other unionist parties at Westminster and Holyrood to see whether they could come together to agree on a package of further devolution measures, including further financial devolution, that they would give an undertaking to put into practice in the event of a no vote. That would have been extremely valuable, as it would have allowed those voting in the referendum to have a far clearer idea as to what no meant. At the same time, we were trying to determine as fully as we could what yes would mean.

Unfortunately, the Campbell II plan, as I think it was called, did not come to fruition. We have seen propositions—some more substantial than others—from the three parties as to what they might do. As you said, we have absolutely no guarantee that any of them would come to fruition. All that I am expressing is my view that further devolution, including further financial devolution, is perfectly feasible and desirable.

You are right that nothing is guaranteed. Unfortunately, the three unionist parties that are represented at Westminster and Holyrood do not appear to be united on what the way forward would be, so we wait to see what might happen, and we do not really know what no means.

Jamie Hepburn: I have a two-part question on currency union. I have been quite frustrated by those who question a currency union because they think that it would be a loss of sovereignty to Scotland. That seems a peculiar argument to me, although I do not know what your perspective is.

In such circumstances, there would be fiscal policy curbs for the rest of the UK as well, as Professor Simpson said. Two sovereign entities would be pooling their sovereignty. By comparison with Scotland's current situation, a currency union would actually be an act of sovereignty and surely could not be described as a loss of sovereignty. Perhaps the witnesses could comment on that from an academic point of view.

Professor Peat, I am aware that you expressed some disappointment to the Economy, Energy and Tourism Committee that the UK Government has not been willing to have technical discussions about the possibility of a currency union. Will you talk a little about that?

Professor Peat: In my paper and, I hope, in the first answer I gave today on currency union, I referred deliberately to a continuing currency union, which is, in effect, what it would be. It would be under somewhat different circumstances, but it would be a continuation of the currency union that we have at this stage.

Secondly, on sovereignty, there would be less scope for independent economic policy decision making—certainly macro and possibly, to an extent, micro—under a continuing currency union than there would be with an independent currency.

Thirdly, on negotiations, I agree that it would have been desirable to have discussed, probably not Government to Government, but at least with the Bank of England in the first instance, some of the important issues of how a continuing currency union would work in the event of independence. I would have expected that to be the first step.

I have read carefully what the governor of the Bank of England and the permanent secretary to the Treasury have stated. Their nuances are somewhat different from what the chancellor and others have said. One cannot take from either the governor or the permanent secretary that there could never under any circumstances be a currency union, although there are a lot of issues and concerns and a lot of things to be thrashed out.

As with some other areas, people do not want to talk about things until after the independence debate. However, that means that just as we do not know what "no" means, we are really uncertain about what "yes" means. I think that independence with a continuing currency union would be very different in the way that it impacted than if we moved down some of the other paths. I would have welcomed further negotiation, but it is not going to happen, even at a technical level, so we have to try and do the best that we can without that negotiation taking place.

Professor Simpson: Much is made of the constraints of a currency union. In particular, Jeremy Peat referred to limitations on monetary and fiscal policy. We must be realistic, however, and realise that for a small, open economy like Scotland's, it does not matter what currency arrangements you have, because your independence, in terms of flexibility on monetary and fiscal policy and its efficacy, is fairly limited. That is true of not only a small economy, but a large economy such as the United Kingdom's that is subject to the disciplines of the international financial markets in determining the long-term and even medium-term rate of interest.

I do not think that we should get hung up about questions of overall, macrolevel fiscal or monetary policy, but I wish to differ slightly from Jeremy Peat's suggestion that as part of the monetary union there would somehow have to be constraints on individual tax policies. I do not see that that would be the case at all. There is no reason that I can understand why Scotland, or any other country in a currency union, could not have particular rates of tax on particular services, commodities or income ranges if it wanted to. The only constraint is on the overall budget balance and on the supply of money and the rate of interest. As I said, those constraints are fairly academic anyway.

Professor Peat: It might not be necessary from an economic and financial analysis to have constraints on individual elements of fiscal policy, but I suspect that, as part of a negotiation, the rest of the UK might wish to see some constraints imposed if they thought that policies such as lower corporation tax might damage parts of their economy that were close to or competing with Scotland's economy. I might see that happening not as a matter of "should" but "would".

So far as Scotland being a small independent country is concerned, Professor David Skilling produced a useful paper for the Scottish Government a year or more back that emphasised that small independent countries have to run very tight monetary and fiscal policies. That is particularly the case when they are dependent on a volatile and somewhat uncertain revenue stream for a high part of their revenue. Yes, Scotland would have to run a tight ship with an independent currency, but other elements would be unleashed in a way that would not be the case with a currency union. Yes, there would have to be a tight monetary and fiscal policy, but an independent Scotland would be able to work its way through that by looking entirely at the interests of Scotland rather than being reliant on the UK to make decisions on interest rates and to set specific constraints on the fiscal side.

Michael McMahon (Uddingston and Bellshill) (Lab): To follow the theme of learning lessons, I am mindful that we often compare apples with oranges and that that is a dangerous thing to do. Also, to continue the fruit metaphor, we should not cherry pick. I am tempting fate by doing something very close to that. Professor Peat says in his submission:

> "One observer has stated that 'the only terms under which a currency union would be feasible would be ones that no self-respecting nationalist could accept'."

We have just discussed the suitability of a currency union and its implications. You suggested earlier that even if we were to have a currency union at the outset, there is some argument whether, in the event of a yes vote, people would accept amicably that we should continue with a currency union. However, at some point, we would be faced with potentially having to break that currency union because of our divergent economies. That looks similar to the situation that happened in Czechoslovakia, where the Czech Republic and Slovakia both amicably wanted to go their separate ways but continue with a currency union. That currency union lasted barely weeks. Can we draw comparisons with that? If so, what comparisons can we draw?

Professor Simpson: I freely confess that I have not studied the currency union between the Czech Republic and Slovakia. My understanding is that it foundered so quickly because one of the parties—I do not know which one—made it fairly clear that it regarded the union as only a short-term arrangement and that it wanted out fairly soon. Once the markets picked up on that, it was over. That is my understanding of the situation, although I might be wrong.

I do not think that there would be any desire on the part of either Scotland or England to break up a currency union in the short term. As people have said, in the long term, if the paths of the two economies diverged significantly, the Scottish Government might think about starting its own currency. However, I would have thought that that would be quite a long way down the line. The only comparable experience was when Ireland left the UK in 1922 and stuck with the pound sterling from then until as late as 1979. It did so without the benefit of a formal currency union, but at least it did so.

I do not think that there is any reason to suppose what you suggest—I struggle to see that happening, although I do not know enough about the Czech-Slovak currency union. I struggle to see how, if there was a continuation of the status quo in the UK, financial market speculation could break it up. However, I may be missing something—I do not know.

Professor Peat: There are two conundrums. The first is how you would decide whether the terms of a currency union were acceptable. Would the extent to which one would have to yield a degree of independence on economic policies in order to achieve the continuing currency stability be acceptable, and what would that mean for trade and, potentially, the finance sector? That is a trade-off, as I have said before. The observer I quoted believes that the terms would be so strict that they would not be acceptable and you would end up with a form of independence that was so light as to be virtually unnoticeable as a change in the Scottish Government's ability to make policies. That would come out in the negotiations, but it is an uncertainty and there is always the risk that the outcome could require a very difficult decision to be made.

The second conundrum was also raised by Malcolm Chisholm, who mentioned the issue of how long a currency union would last and questioned how I could discuss the need to move away from the currency union and yet, at the same time, accept that to be a stable arrangement. It is difficult. From my limited understanding of the Czech-Slovak problem, I believe that it was different. First, there was no long-term expectation. Secondly, the two countries were so different that it was clear to the markets which was the strong member, which was the weak member and which way the currencies would go if they broke up. It was a one-way bet.

If Scotland and the rest of the UK were in a currency union and the oil sector was doing very well, which way would the currencies go if the union split up? Would the Scottish currency be stronger or weaker than the pound? I do not know. A lot would depend on the policies and what was happening in the offshore sector and so on. I think that it would be necessary to have a perceived commitment for a considerable number of years. David Simpson is right in saying that, if the divergence of the economies was the cause for moving to an independent currency, that would happen some years down the turnpike rather than in the very short term.

That would allow the markets to see a currency union as stable for an extended period and be aware that they would have plenty of warning if that were likely to change, which would enable them to make preparations. It would give Scotland time to establish its credibility in such a way that moving to an independent currency would be something that did not cause the markets to take fright, which would enable a rational and manageable process to an independent currency, if that was needed.

It is very different from the Czech and Slovak situation. It is also very different from Ireland. That was 92 years ago and economic and financial circumstances are slightly different now than they were then. Ireland is a fascinating case. It was very generous of the United Kingdom to allow Ireland to go independent with no debt. I am not sure whether it knew it was doing it at the time, but I do not think that one can expect the same generosity or stability without a formal currency union, as happened when Ireland went its own way.

11:15

Professor Simpson: I do not pretend to be an expert on Irish history but I do not think that it was a question of generosity. I think that it was a necessity. Both sides wanted a peaceful settlement and it was done in exchange for moving the border, which only goes to show my point that the question about currency union, debt and everything else will all go into one great big melting pot. I, for one, would happily give up our claim to Berwick and Carlisle if in return we could cancel our share of the UK debt.

Professor Peat: That may not be sufficient for the UK Government this time around.

Michael McMahon: Because moving the borders in Ireland worked well.

The situation that you have outlined is about the desire for a currency union in the best interests of both parties. However, that still leads to the conclusion that, at some point, the divergence will create a force that will see Scotland, one way or another, going to its own currency—plan B, if you like, except that we do not have a plan B. We are told that there will be a currency union. That is all that is on the table. How important is that plan B to the financial sector, the markets and those who could be assessing Scotland's credit rating?

Professor Simpson: There is no plan B for the simple reason that there is an implicit plan A and a half, which everyone has been talking about. I cannot believe that a Government would cut off its nose to spite its face, and no one south of the border believes it either. However, in the very unlikely event that Westminster decided to do that, there is the option of simply continuing to maintain sterling on an informal basis without an agreed arrangement with the rest of the UK.

In many ways, that would be to Scotland's advantage, because it would not be constrained by the type of agreements that we are talking about, as far as budget deficits and monetary controls are concerned. However, I think that everyone who has considered this agrees that the best solution would be an agreed monetary and fiscal arrangement that we call a currency union. I am perfectly sure that that is what will happen.

Professor Peat: The question of sterlingisation has been raised previously. My concern is that if there was no perceived security on the currency arrangement, not only would there be a risk that the markets would determine that that justified higher borrowing costs for Scotland, but there would be the risk of capital and corporate flight. That is because they would see a lower risk solution, which would be to locate funds and activity within the rest of the UK, if that was where the major markets were and there were risks that an independent Scotland, as part of a currency board or sterlingisation arrangement, might be subject to volatilities, high interest rates and uncertainties. I am not sure that that is an outcome that would be stable and in the interests of Scotland, which is why I would devote considerable attention to trying to find a currency union solution that was acceptable to both parties, given the implicit logic, which David Simpson has repeated, that it would be in the interests of the rest of the UK as well as in the interests of Scotland if the right solution could be found.

On whether we need a plan B at the outset, it is probably much easier for me as an independent commentator to talk through the prospect of moving to an independent currency in the fullness of time as the economies diverge than it would be for the Scottish Government. It would be appropriate for the Scottish and UK Governments to indicate that the currency union was a relationship that they anticipated continuing for an extended period of time, even saying that it would continue for at least 10 years, or whatever it is.

I am pointing to the logic of what would happen if you had different policies, a different path for the economy and different priorities in Scotland, as compared with the rest of the UK. Over time, it might become desirable to break the tie with sterling and to accept that that would lead to a different outcome on the exchange rate. That would be done, however, in order to look to the interests of Scotland in the new environment, once one had established the management of the economy, once one had the confidence of the markets and once the financial sector and others were secure in the knowledge that this was a Scotland that could and would run its own affairs fully in a way that they found satisfactory and that they wished to be part of.

Michael McMahon: Thank you. That is helpful in understanding the potential scenarios, but looking backwards, I note that Professor Simpson's paper asks:

> "How Did The UK Government Get Into This Situation?"

We could speculate about the position that Scotland would have been in had it been an independent country in 2007. Indications from people such as the First Minister, who thought that the regulation of the UK banking sector was gold plated and wanted lighter-touch regulation, could be cited as an argument that we would have been in a worse position than we were as part of the United Kingdom. If we look at the smaller countries that were independent states at that time, we see that Irish bank assets were 4.4 times Irish GDP and that Iceland's bank assets were 9.8 times its GDP. The assets of HBOS and the Royal Bank of Scotland alone were 21 times Scotland's GDP. We would not have been in a strong position, would we?

Professor Simpson: There are two points to make about that. First, it would depend on how long Scotland had been independent for. If it had been independent since 1990, it would have built up a fairly healthy oil fund to cushion us against any such fluctuations. I agree that it is impossible to speculate on how an independent Scotland would have conducted its affairs over that time. When you are in a crisis, it is too late to think that you can get out of it easily.

It is a bit like being drunk and then having a hangover. There is no real cure for a hangover; just as the only cure is not to get drunk in the first place, so the only cure for a recession is not to have the preceding boom. That is a lesson that we are painfully learning now. We read commentaries in the papers all the time from people worrying that the present housing boom is getting out of control, because everybody realises the damaging consequences of that happening again.

Even in 1990, knowing that things should not be allowed to get out of control was not rocket science. Way back in the 1950s, the distinguished chairman of the Federal Reserve board, William McChesney Martin, famously said that the role of a central banker was to take away the punchbowl when the party started to get going. What happened in the early part of the 2000s decade was that central bankers, not only in Washington but in London, did not take the punch bowl away. In fact, they topped it up quite regularly, which led us into the situation that we are now in.

The relationship of that to your question is this: had we had a prudent Scottish Government in 2007, we would have been in a good position; had we not had a prudent Government, we would have been in a bad position. By the way, one of the criteria of prudence would have been to have in place legislation providing for what would happen in the event of a bank's becoming insolvent.

Professor Peat: Having RBS and HBOS headquartered in Scotland was extremely important when they were genuinely headquartered here and when the wider effects on the wider economy were substantial. When decisions on procurement were made here, when they used the services of Scottish lawyers, actuaries and accountants, and when there was a career structure so that high-fliers could expect to stay within the Scottish labour market and progress, it was very good for Scotland because it provided high value-added, high-skilled people who would work in those organisations, move out to start their own businesses and develop the rest of the financial sector. The overall impact was large.

Those days went before the recession. As I stated to the committee a number of years ago, the centre of gravity of RBS and HBOS moved down south, so we do not have the benefits of the headquarters effect in the same way that we had. However, as long as those companies are formally headquartered here, we will still have the risks in the event of Scotland's becoming independent. As you have suggested, Mr McMahon, those risks are of substance and could be damaging, even given the lower state that those banks are now in.

I am interested in having a stable and secure banking sector that delivers services that Scottish households and companies want in a manner that relates to their interests and which understands the environment in which they operate. To me, that is what matters. Having a smaller branch office—as some people call it—of RBS is fine, provided that it meets the needs of the Scottish economy, delivers investment funds when appropriate and ensures that household needs are dealt with on a sensible, risk-diverse but appropriate basis.

That is why I want a diverse Scottish banking sector and why I welcome new banks, whether Tesco, Virgin, Santander or HSBC, developing their activities in Scotland. I want a wide range of banks, and all of them considering the interests of the Scottish business community—large and small—and Scottish households. That is what matters.

How can we achieve that? If it involves the headquarters formally moving down south, so be it. If it involves the risks of investment banking exiting Scotland, so be it. Let us have a banking sector that serves the interests of the customers in Scotland. Let us also encourage the rest of the financial sector, which has done remarkably well over the period following the banking debacle and has enabled the sector as a whole to remain strong and important in our economy. Let us consider what matters for Scotland under independence or the status quo and let us focus in particular on meeting the requirements of the business community and households in Scotland in a customer-focused manner.

Michael McMahon: I agree with Malcolm Chisholm and Jamie Hepburn on the desirability of an oil fund. It is regrettable that we did not make that decision; the consensus is that it should have been made. I also agree with Jamie Hepburn that, when advice comes from civil servants, it should be taken and not rejected on the basis of party politics or party interests. In fact, we will debate a similar situation in the Parliament this afternoon.

The point, however, is that although Norway set up an oil fund, it remains Norway; it has not become nirvana. Even with its oil fund, it has some of the highest rates of personal debt in the world. Its healthcare is not free; 28 per cent of employment there is part-time; and, according to the Gini coefficient, it rates higher than the United Kingdom for wealth inequality. Moreover, it does not invest in capital in the way in which we do in the United Kingdom. For example, we have a motorway network that Norway does not have and does not aspire to have. We do things differently with our money than the Norwegians do with theirs, even though they have an oil fund.

11:30

That brings me back to the point that I started with: you cannot compare apples with oranges, and you cannot cherry pick to create the impression that all would have been well if we had had an oil fund. It would have been beneficial in certain respects, but it would not have solved a lot of the problems if the political attitudes towards the financial sector and the banking sector had continued in the way that they did.

Professor Simpson: I am sure that you are right. I would not for a moment say that having an oil fund would solve all your problems. Obviously, that is not the case. It depends on a lot of other things. However, I would say that I would rather be a minister of finance in Norway than a minister of finance in the UK or even in an independent Scotland. I think that that would be a much easier job.

Professor Peat: I worked in the Scottish Office for eight years under Gavin McCrone. When I had done a piece of analysis, it was not unusual for the minister or a senior civil servant to say, “Thank you, Jeremy. That is a splendid piece of analysis and we’re very grateful for the work and effort you’ve put into it. However, there are other priorities that must also be taken into account, so we are going to do something totally different from what you have suggested.” That is partly the way life is. That is why I suggested that transparency is important when it comes to ensuring that one casts a light on decision making. That said, I do not necessarily mean transparency in terms of civil servants or ministers going out and publishing whatever they want to. There must be constraints in that regard.

Therefore, I am positive about the establishment of something like an Office for Budget Responsibility and about the development of the kind of capability that exists at the Institute for Fiscal Studies. I think that the light cast by those bodies—in the case of the OBR, officially, and in the case of the IFS, with a robust and strong reputation—is extremely important. Had a body of that ilk and reputation commented on the need for an oil fund, got it out into the public domain and come before a committee such as this to say, “This is the justification for going down that route, and you should call the minister to account and ask why he is not doing it,” it would have provided an opportunity to improve decision making. It might or might not have led to the right decision being made, but it would have cast light on the issue and provided evidence-based, informed analysis that would have enabled elected representatives to ask the questions that would have held Government to account. That is valuable, and it is needed in Scotland, whether under this regime or under independence.

The Convener: As three members of the committee still want to ask questions, I will call a recess to allow a natural break and give folk a wee bit of a breather. Before that, however, I want to make a couple of comments and see whether the panel has any response to them.

A couple of months ago, *The Sunday Times* ran an article about Norway that said that it had the world’s highest per capita productivity; that part-time employment was a choice because people preferred a higher quality of life instead of working to increase an income that is, in terms of purchasing power parity, 58 per cent per capita higher than that of people in the UK; and that there is an exceptionally low level of child poverty. It also said that since its independence in 1994, Slovakia has had the highest rate of economic growth in Europe and is the world’s largest per capita manufacturer of cars, even though it did not have a car manufacturing industry to speak of before 1994.

Do David Simpson and Jeremy Peat agree that neither independence nor staying in the union will, of themselves, lead to success and that, clearly, it is the policies that are enacted, either in the union or in an independent Scotland, that will make the real difference to people’s lives, not the constitutional change in itself?

Professor Simpson: I agree with that very much. I especially like the fact that you started off with the word “productivity”. Although it is a boring-sounding word that economists use, it is the key to everything else because, without improvements in productivity, you will not get growth in total output and thus growth in tax revenues. Without growth in tax revenues, you will not be able to sustain your public services, let alone look for improvements in the quality of those services.

Professor Peat: I, too, agree. Indeed, I addressed that point in the annex to the note that I submitted to the Economy, Energy and Tourism Committee in March. In the 30 years in which I have been examining the Scottish economy, I have seen it continue to have disappointing levels of productivity, disappointing levels of new firm formation, disappointing levels of growth of firms and disappointing levels of contributions on the part of business to development and innovation, and I do not know why. It is not just a matter of the banks not funding things, so it cannot be cured by having a Government bank that pours in money in different ways. It is hugely important that we try to understand this disappointing productivity. What is different in Norway? We have an amazing success in our higher education research and development sector, but it has not translated into an innovative set of sectors in the economy or high levels of business investment in research and development.

Why are we at the top of the league table for higher education research and development and at the bottom for business research and development? What causes that? Why do we have a low level of business investment? Why do we have insufficient companies with the ambition to export and diversify their exports? What is going on that prevents all the marvellous attributes that exist from being translated into a vibrant, successful, innovative, high investment and high value-added sector in Scotland? I do not know the answer to that, but I would be far more interested in exploring that and finding ways of changing that pattern than in getting bogged down all the time in the constitutional debate. That issue matters to me more than anything, and there are means within the existing settlement of exploring and examining it.

There is something going wrong that I do not yet fully understand. The greatest solution for a successful Scotland will come through working on innovation, investment, ambition and development across a range of sectors, and through becoming a high value-added, high investment and high level of innovation economy. That is what Scotland could be, and that, to me, would be success.

The Convener: I was going to ask about that issue if it did not come up in colleagues' questions later. In the meantime, we will have a break until about 11.45.

11:37

Meeting suspended.

11:49

On resuming—

The Convener: We shall recommence the session. The next person to ask a question is Jean Urquhart, who will be followed by Gavin Brown.

Jean Urquhart (Highlands and Islands) (Ind): I thank both witnesses for the discussion that we have had so far, which has been fascinating.

Reference has been made during this morning's discussion to the kind of advice and interpretation of the economic situation that might be available from the fiscal commission, or the equivalent of the OBR. You said that a few people saw the recession coming, but you also said that it is impossible to have a crystal ball to see what will happen next year. Those are slightly contradictory remarks that suggest that if we put enough people to work on a plan, they could see the future. Jeremy Peat suggested that we need to have a 10-year plan for oil and so on. On the other hand, it is impossible to say what excitement might happen, what discovery might be made or what opportunities might arise for a nation, a people, a county or a town. How would you reconcile that?

Professor Peat: One can never get beyond the fact that all forecasts are more or less uncertain—one must accept that. However, what the OBR and the IFS do in the longer-term arena is to produce a public sector balance sheet for 10 or 20 years ahead that looks at various alternative scenarios for key parameters and at what impact variations in those could have on the public finances. That could mean looking at demographic change and its impact on health expenditure or looking at the various possible streams of revenue from North Sea oil and gas under different scenarios, and getting a feel for the context of the different scenarios.

That is good business planning, if you like. I am chair of the board of trustees for the Royal Zoological Society of Scotland, and we have different scenarios for whether we do or do not get a baby panda. We plan on the basis of the less optimistic of those scenarios and hope that the more optimistic comes to pass. One undertakes one's five or 10-year planning on the basis of looking at not only central expectations but scenarios around that. The longer-term work enables an understanding of which are the critical parameters and getting a feel for that. It is not done to be 100 per cent accurate, because that will not happen; it is just to get that feel.

The OBR has various roles at UK level. It produces the forecasts that are used for the public finances, which is not proposed at the moment in Scotland but which I suggest would be desirable in the event of independence or very substantial fiscal devolution. The OBR produces the forecasts for individual budget measures and their cost implications. The proposal that Mr Swinney put before this committee about three or four weeks ago is that the Scottish fiscal commission should comment on the Government's forecasts rather than provide them for individual elements. Maybe that is satisfactory when the extent of devolution under the Scotland Act 2012 is limited. I am disappointed about the amount of resources that would be given to the fiscal commission. I would like to see it given a little more opportunity to at least comment on the wider forecast and to start the process of looking at the longer term.

Certainly, when we come to independence or very substantially enhanced fiscal devolution, there will be a need for the longer-term balance sheet approach alongside very severe inspection, at the very least, of the Government's forecasts in a transparent manner that informs this committee and the public and enables them to judge whether there is a degree of overoptimism or insufficient clarity in some areas that casts doubt on the forecasts for the budget and the implications for the economy.

I am a great believer in transparency and in scenarios being developed to understand the alternative policy that the public finances and therefore the economy could adopt. I am also a great believer in having very well-resourced bodies that can do that and have a status that enables them to be listened to and which can enable this committee and others to be influential and effective in their crucial role in our democracy.

Jean Urquhart: Do you think that the OBR is too close to the Westminster Government?

Professor Peat: No. I have huge respect for Robert Chote and his people. We have had the great advantage of having them up every year, sometimes two or three times a year, and I have hosted them at the David Hume Institute in the past just as they have given evidence here. I do not think that we can say that he is too close to the Government. He does a very good job of calling the Government to account.

Robert Chote also examines whether particular changes in policy will lead to the conclusion that the Government assumes. There have been occasions when a policy has been changed as a result of his investigation, or the Government has accepted his analysis and changed its view of the implications for the public finances. He has a good track record. He has the benefit of using a sophisticated Treasury model that is open and available. We need a good model, and you have heard evidence that one is being developed under the Economic and Social Research Council programme. Scotland needs something. The model at the Fraser of Allander institute is a start, but we need something of more substance as we go forward. No model is perfect, but we need something that will help us to look at the interactions and interdependencies, as Peter McGregor did at an earlier committee meeting.

Transparency matters. If we go into independence and we have all these uncertainties about public finances, and stories that it will be tight, it would be disturbing if Government produced all its forecasts without turning a very strong searchlight on them that would enable them to be questioned. My preference would be for some of that work to be done externally and delivered to the Government. That looks unlikely so, at the very least, there needs to be a strong searchlight so that there is effective scrutiny.

Professor Simpson: In the earlier part of my career, I was an academic and I did my share of forecasting, including scenario forecasting. I have since come to regret it. I am extremely sceptical about the possibilities of accurate forecasting of economic affairs.

Jeremy Peat is right to say that if you have an unbiased outside body, you can remove the elements of bias from a forecast. Unfortunately, you cannot remove the much more difficult element, which is that you cannot know what the future holds. That is true the further out your forecast goes. Even one year from now, as I said earlier, we do not know what interest rates will look like, we do not know what the stock exchange index will look like, and so on. As we go beyond that time, things are even less certain.

It is not down to the incompetence or lack of skill of people in devising ways of forecasting; it is just because of the sheer unknowability of the future. Just before I came to the committee, because I thought that this question might come up, I took the opportunity of looking up the Treasury's forecasting record. The only study that came up on Google was one that was made of the period from 2000 to 2009, which was of the budget forecasts by the Treasury one, two and three years ahead. The results were pretty depressing. That was not because the Treasury does not hire smart people; it is just because of that unknowability.

With all due respect to the IFS and the OBR, they will encounter the same problems. My conclusion is therefore that, before you are inclined to accept anybody's forecast, look at their track record. The OBR has not been in business long enough to have much of a track record, but the IFS has. I have neither the time nor the resources to analyse its forecasts, but it would be extremely instructive to do so.

12:00

Jean Urquhart: I know that there has never been a forecast about demographics that was right.

Professor Simpson: Demographic forecasts are rather different because they are based on biology rather than economics. Having worked for Standard Life, I am acutely aware that the whole business of life assurance companies is founded on the predictability of human mortality and morbidity as a whole, not for the individual. I could not say how long you or anyone else here would live, but we can do that for the totality. However, that is the exception. So far as human affairs that involve interactions between people are concerned, in my view they will remain for a very long time an impenetrable fog. What is the policy lesson of that? It is that you must err on the side of caution and be extremely cautious in making your budget provisions. That brings us back to the oil fund, because if you build up a big chest of reserves, you are in a much safer position to deal with unforeseen and unforeseeable calamities when they come along.

Professor Peat: I do not disagree with anything that David Simpson has said. In fact, the forecasting record is slightly worse than he said, because we do not even know where the economy is now. The data will be revised over the next several years, so the path of the past two or three years will look very different to economic historians in 20 years from how it does now. When we do not know where we are, it is rather difficult to try to forecast where we will be. However, that does not mean that one cannot assist decision making by looking at the issues and factors, and the alternative paths that are possible. I entirely agree with David that doing that leads to taking a cautious approach, particularly in the early years of a small nation.

Jean Urquhart: I think that two points are related to that, one of which is that boom and bust continues. We hear what I consider to be the quite frightening phrase of "back to normal" with reference to the economy. I am not quite sure what "normal" is, but if it means what was normal in 2007-08, that is not a comfortable place to be. How far back would we go to get to "normal"? I run a small business that has lived through three recessions, so is it normal just to assume that another recession might happen? That would mean that boom and bust will continue as long as we follow the same kind of economic path as we are on at the moment. What would shift that to make us look at economics differently? There are organisations out there that think that we should make quite drastic changes to how we do our economics so that they are not so market led.

Professor Simpson: When people talk about being "back to normal", what they are looking back to is the period from—Jeremy Peat can correct me on this—1995 to 2005, which was a period of fairly sustained growth, low inflation and high employment. Unfortunately, it did not last, and I do not think that we truly understand yet why it happened and why it did not last. We would all like to get back to it, though.

As I said previously, the only way in which we can avoid significant downturns or recessions in the future is not to have the preceding boom, and the way of avoiding that is by having very cautious monetary and fiscal policies—in other words, not running up big deficits and not having rapid monetary expansion. That is easier said than done, and of course additional factors always come along that we did not entirely expect.

For example, there is no doubt that a factor in the financial crisis was not just the loose monetary policies in both the US and the UK but the fashion that grew up in the banking and investment banking communities for derivative instruments that were packaged and repackaged and traded until nobody knew what it was they were buying and selling. Once it was realised that there were some nasty packages floating about, it became rather like the old game of pass the parcel in that when the music stops nobody wants to be holding the parcel that has all the bad mortgages in it but nobody knows which one it is. Some of the banks began to realise that some of the people they were dealing with were passing them dud packages, and then they started lending them money, which is what is called counter-party risk. That was perhaps a unique element in that particular crisis.

As I have said, since the middle of the 19th century we have had the periodic cycle of boom and bust. However, each time it happens there are some slightly different elements. There is the general pattern, but there are also elements that are peculiar to a particular cycle. I do not know what that will be the next time. Everybody is looking at the housing market right now, partly because it played a big part in the most recent episode. However, that does not mean that it will be the housing market next time—it might be something else. As I said earlier, as long as we have prudent and cautious monetary and fiscal policies we should be able to protect ourselves from at least the very worst recessions.

Professor Peat: I agree with what David Simpson said. In terms of getting back to normal when normal was good, I had 12 years as group chief economist at RBS from 1993 to 2005, and I chose my period very fortuitously, because that was a good time and when I retired was a good time to retire. I am not saying that I would have in any way been better than my successors or others in forecasting what was going to happen and preventing it. However, 1993 to 2005 were very good years for our economy and very good years to be engaged in an economic role at RBS.

We have to be careful about what we do in trying to get back to normal. We certainly have to have conservative monetary and fiscal policies for an extended period. With regard to boom and bust, we are of course paying attention to the housing market now, and I am not sure that I would have given top priority to stimulating demand in the housing market. I might have given more priority to stimulating supply and helping to equalise the position in that way. We certainly need to watch that we are not going back to something like the situation last time round. However, as David has implied, the next problem will be a new one rather than the old one repeated. We must learn to be prepared for that and the best way to do that is to be secure and conservative in having stable policies.

The only other point that I would make is that it is important for Scotland—I go back to the national performance framework—to be absolutely clear about what it wants. If we want a different set of priorities and to give greater priority to equity within our population than to growth per se, let us be clear on that. We can then consider policies against a clear and precise set of objectives that are Scotland's and which Scotland wishes to measure and judge performance against, rather than just accepting that the fastest rate of growth is necessarily the best. Let us be clear on what our objectives are.

Jean Urquhart: Finally, the point that was left hanging just before the suspension was your statement about innovation and what is inhibiting growth in manufacturing, exports, energy companies and so on. I have two points to make about Scotland as an independent country, although one is only kind of relevant. First, the strength of the pound perhaps suits another part of the United Kingdom better than it fits with Scotland. Secondly, I believe that there is such a thing as a business, commercial, industrial culture that can exist in any country, which comes with the belief that actually you are working within a unit with people that you know; and I think the smaller the unit, the better. It is interesting to look at how some of the smaller countries have come through the recession.

There is a great debate about the money for research and development, but all the money in the world is no use if we are not using it and, compared with other countries, Scotland is not using academia as it should. There are too few direct links understanding the kind of R and D that is happening in the universities and how we might use it.

There needs to be an energy for that—it is difficult to articulate, but it is essential for an independent Scotland—and the energy that is needed is possible with a much smaller country.

I will probably not be allowed back in again, so I will make one final point. Jeremy Peat said that Scotland might not legally be obliged to pay its debt but that, morally, because we have had the use of the money, there needs to be some payback. I question his assertion that the market would be less keen to recognise Scotland as an independent nation if it somehow defaulted on that debt. The market defaults on all kinds of things and is hardly held to some kind of moral high ground.

Professor Peat: On sterling, one cannot blame a strong pound for what has been happening in the Scottish economy. I do not necessarily believe that an independent Scotland with its own currency would tend to see that currency depreciate against sterling rather than appreciate. That is uncertain. One cannot say that the value of sterling is wrong for Scotland; that is a difficult argument to sustain.

The points that you made on culture and R and D are fascinating. Is there a culture in Scotland that applauds endeavour to create and run businesses and accepts that failure happens, that it should be accepted and that people should be encouraged to try again, as happens in the US and elsewhere? Is there a drive for businesspeople or students leaving university or further education colleges to create and grow businesses? It does not seem to exist to the same extent as one might hope. Would an independent Scotland unleash those animal spirits? Perhaps. Perhaps it would be somewhat different. No one can tell. I sometimes think that, in Scotland, success and failure are equally damned. Failure is not accepted as inevitable in entrepreneurial development and being too successful is only now becoming applauded. The culture needs to be looked at.

The R and D point fascinates me. There is something wrong with the incentive mechanisms for the use of R and D in higher education institutions. Many years ago, I was vice-chairman of the Scottish Higher Education Funding Council. The rounds of funding were determined on the number of articles that were generated or the number of academic success stories rather than whether the research was being used. If an academic was doing great research on genomes A and B, and genome A was going to get the most articles and genome B was going to lead to a booming life science business, genome A somehow took precedence because the incentive mechanisms were set up in that way.

One needs to encourage academics to want to make best use of their work, directly or with others, for the success of Scotland. One also wants to encourage businesses to want to understand and use that R and D. That is not yet happening. It is tremendous to have the success in HE and R and D, but it is disappointing that it is not being translated into the innovation for which we are looking. I do not know how we achieve that, but it merits attention.

Finally, on debt, it may not be right that markets would act in the way that I suggest they would, but it is likely that they would. Any failure to take on the level of debt that the UK and others deemed appropriate, and any suggestion of default or anything akin to it would be likely to lead to markets demanding higher interest rates for borrowing by an independent Scotland. How high, I do not know.

It is critical that, in the early years, Scotland demonstrates its credibility and an appropriate approach to the public finances and the running of its economy, so that it secures its position and can work with the markets and do the best that it can do for its nation.

12:15

Professor Simpson: I agree with that final sentence. The single biggest factor determining the rate of interest at which an independent

Scottish Government would begin to borrow is the market's judgment of the prudence of Scotland's public finances and minister of finance, whoever that might be.

However, I do not agree at all with Jeremy Peat on there being any connection between the notional share of the UK debt that might be negotiated and any question of default. There is no question of default, as I said. I do not think that the markets will think like that. However, I accept that I do not know; we shall have to wait and see.

More important is the point that Jean Urquhart raised about culture. Like Jeremy Peat, I do not have a simple answer on culture—who does? However, I think that there is one factor that might link economic success with constitutional arrangements, which is confidence. One of the reasons why there is an observably lower rate of investment and innovation among Scottish businesses is that we just do not have enough people who are confident about the future. We do not have enough entrepreneurs who are prepared to take risks.

That being the case, I do not think that we can wait until such people come along by natural selection. We have to create an environment that attracts businessmen and entrepreneurs from all over the world. We must make an economic environment that is attractive to such people.

Gavin Brown (Lothian) (Con): Professor Peat, in your paper you said of the proposed fiscal policy commission:

> "Clearly the role of the FPC in the context of the Scotland Act is limited. It will be examining the Scottish Government's estimates for revenue to be raised. But even in this limited context a few voluntary hours input seems small as does the sum available to buy in external input."

Will you expand on your view?

Professor Peat: I have seen only the paper from John Swinney and the discussion that the Finance Committee had with him, but my understanding is that there are to be three members, who will work on a voluntary basis with, I think, £20,000 being made available for research to support their work. If they are buying in analysis on, say, three different items of taxation, £6,750 or so per item is not a lot.

On the proposal to rely on volunteers, I am sure that there are good people out there who would undertake the work, but their time is likely to be limited. One would want them to take the work very seriously, because it would be the starting point for doing that type of analysis and developing the role of a commission that would be likely to expand.

What is proposed looks pretty limited, even as a kick-off. I know that funds are tight, but I would like to have seen some payment, at least for the chairman of the commission—on a part-time and limited basis—and more funds for buying in good quality research, preferably from Scottish higher education institutions, to enable the commission to develop its ability to analyse the Scottish economy and elements of it.

Not enough work is going on in Scotland in the higher education institutions to analyse the Scottish economy, if we set aside the work of David Bell, Peter McGregor, Brian Ashcroft and others—all of whom tend to be of my generation rather than the next generation, which is unfortunate.

Gavin Brown: I guess that both you and Professor Simpson will say that output is more important than input. However, do you have a personal view on what input sum should be provided to kick the commission off properly? Are you just saying that the existing sum seems low?

Professor Peat: I do not have an exact figure in mind; I just know that £20,000 does not go far these days, especially now that the full costs of HE institutions, rather than just the marginal costs, need to be paid. I would have preferred that there had been analysis done of the work that will be required, after which an indicative costing could have been given. The figure that has been produced looks somewhat arbitrary.

Gavin Brown: Let us move away from that issue. My next question is for both, or either, of you. If Scotland were to go independent in March 2016, what borrowing costs would an independent Scottish Government be likely to face, relative to the UK Government?

Professor Simpson: I have not thought about the numbers, and I do not know of any reliable estimates. I am quite sure that there would be an initial premium on the costs. As I have said, a big factor would be markets' subjective assessment of the capability of the Scottish Government to repay the loan, which would depend primarily on their judgment of the personnel and policies of that Government.

Professor Peat: Like David Simpson, I have not undertaken research on the subject, although I have seen the work for the National Institute of Economic and Social Research that was carried out by Angus Armstrong and Monique Ebell, which looks to be as good quality as such research can be at the moment. So much would depend on the form that independence took, the currency arrangements, the arrangements for management of the public finances and so on. The markets would look at the extent to which rigorous and secure policies were in place and at the currency union, or whatever the way forward was. There would be a premium, but if it was all managed well, that would be relatively small and could be short lived. As Scotland's reputation was built and enhanced, that premium should reduce.

Gavin Brown: Professor Peat used the phrase "currency union". You have both answered a number of questions on currency union, so I will ask some different questions around it. Are there any good examples of countries that have separated and successfully retained a formal currency union?

Professor Simpson: Did you say "retained"?

Gavin Brown: Yes.

Professor Simpson: I am not sure. I cannot think of any apart from the Czech Republic and Slovakia, and their currency union went the other way. I do not have any evidence on that. Throughout history, there have been a number of currency unions that have been quite successful. The one between Belgium and Luxembourg lasted for quite a long time.

As I said before, we talk about currency union as though it were something new, but we are not creating something new; we are simply continuing the status quo but adding certain agreed constraints on both Governments—we must not forget that—concerning their behaviour. That is all. I cannot foresee any forces that would tend towards the breaking up of such a currency union once those constraints had been agreed.

Professor Peat: I agree that the number of examples of currency union is limited, as is the number of sterlingisation-type operations. Perhaps the classic positive example is Hong Kong, but the reserves that Hong Kong holds are beyond the wildest dreams of avarice as far as an independent Scotland is concerned. Those reserves enable Hong Kong to have a financial sector of substance while maintaining a stable relationship with the dollar, which the markets acknowledge as being secure.

I do not think that there is a good comparable example out there. I think that currency union is achievable, but the exact basis on which it is achievable remains to be determined.

Gavin Brown: Let us assume that there is a yes vote in September and that a currency union is agreed between the two Governments. I want to explore the idea of permanence, or how the market would see that that would not just be a short-term arrangement. Senior people have commented in the press that a currency union would be for the first couple of years, after which we would do our own thing. The white paper says quite openly that it would be up to the people thereafter to decide what currency arrangement they prefer. There are indications out there that some people would prefer not to be in a currency union for terribly long. Were that to work, what would the UK and Scottish Governments need to say to give a clear indication to the markets that the agreement was permanent or semi-permanent? Would a formal declaration be needed? Would a timescale be needed? There would be some suspicion, at least on one side, that the currency union would not be permanent.

Professor Simpson: I agree. Jeremy Peat, in answer to another question, suggested 10 years as a period of declaration. That seems to be perfectly sensible.

Professor Peat: The problem is that, even were such a declaration to be made, it would always be up to the will of the people of Scotland to change that, as is stated in the white paper. Therefore, in addition to any declaration, there must be a belief in the markets and elsewhere that the currency union would be sustained.

You mentioned that some people who favour independence do not see a currency union as being the right way to go for an extended period. The Scottish Government and other parties, including others in Scotland, would have to see it as being the right path for an extended period so that pressure would not grow for moving rapidly to an independent currency in order to achieve the flexibility that would, to an extent, be constrained by being part of a currency union. Currency union would have to be seen to be the accepted great will of the Scottish people and Scottish politicians, and a statement that it would last for an extended period would be needed. That would provide the security that would allow for a less significant premium on interest rates, and allow stability for the financial sector and others.

Professor Simpson: There is a risk of our getting hung up on subjects that academics like to debate, such as what would be the optimal currency arrangements—an independent currency, a common currency with the rest of the UK, attachment to the euro or even something else. The truth is that it will not make much difference. Let us take three countries that are—when we look at them from here—broadly similar to Scotland. Finland is a fully paid-up member of the eurozone. Sweden has—I think I am right in saying—a fully floating currency of its own, and Denmark has its own currency, but tries to keep it related to the euro.

The prosperity of a country is very rarely down to its choice of currency. That should not be surprising; we all know that, apart from luck, prosperity is down to the colleges of people in the country and the decisions that they make. The question about what financial arrangements the country has is entirely a second-order matter.

Gavin Brown: Thank you. I will move on. Various committee members have referred to the oil fund in their questions. Most analysts have projected, for the first year of independence—were it to happen—a deficit of between 5 per cent and 6 per cent. How could money be put into an oil fund if the country was running a deficit of 5 per cent or 6 per cent? Would we not then, in effect, be borrowing money in order to put money into the oil fund? Would that be feasible at that stage, or would that be done once the country had moved into surplus?

Professor Simpson: First of all, I do not accept such projections of numbers, for the reasons that I gave when we were talking about forecasting. It is open to the Scottish Government to alter its budget in a number of ways; it does not involve merely projecting numbers in the same proportions as they are at the moment.

However, I agree that given that we are—as we have both said—entering a period of fiscal tightness, there will not be a huge amount of scope for putting a lot of money into an oil fund right away. I would not pretend otherwise. I do think that it should be an early objective of a Scottish Government to start to put money into an oil fund, although I would not try to say in what year that should be done or how much should be put in.

12:30

Gavin Brown: I take your point that you do not accept projections and so on. Theoretically, though, should a Scottish Government start putting money in before a surplus is reached, while it is in deficit, or should that happen once we are in surplus, in whichever year that happens to be?

Professor Simpson: It should be the second of those options.

Gavin Brown: You think that it would make sense to do that only once we are in surplus.

Professor Simpson: Yes.

Professor Peat: I have a slightly different take on that. On the first point about what the deficit would be in the first year of an independent Scotland, that will depend on policies. What I have seen thus far of the proposed policies is that they are quite strong on additional expenditure items but not very strong on additional tax measures. I do not see anything yet that persuades me that the deficit would be likely to decline compared to what it would be under the status quo, in constitutional terms. That is quite tough. The Scandinavian models, for example, may be more equitable societies in many ways, but they also tend to be higher tax economies. We have to face up to the question about how, if an independent Scotland wishes to have high spend in a number of areas, it wishes to finance that. I do not think that the answer is to run an even larger deficit than would otherwise be the case.

On the oil fund, it would be desirable to set out an anticipated path for the fiscal deficit that was seen as prudent and likely to sustain the public finances. In an exceptional year for oil and gas revenue, which took it well above the expected revenue stream, some or all of that revenue could be stashed away in a fund. As I have said before, if the level of revenue was below expectations, the Government would have to take that on the chin within its budgetary arrangements. I would not necessarily wait until there was a surplus, but I would put something into a fund only if receipts were greater than expected and if doing so were consistent with appropriate management of the public finances.

Gavin Brown: I am grateful for that. Thank you.

John Mason (Glasgow Shettleston) (SNP): I want to follow up on that point. I presume that there could be a fund, as various organisations have, without its actually having cash in it. As you said, Professor Peat, in a good year in which there was a bit of extra money from oil and gas but we were still running a deficit, the money could be put into the fund on the Government balance sheet and ring fenced and, in a sense, lent back to the general fund, rather than separate borrowing being done.

Professor Peat: I am not sure how that arrangement would work, and I cannot think it through sitting here. I would move resources into the fund only if the public finances were deemed to be as was required, and the level of revenue from oil and gas was above the expectation that was consistent with that appropriate state of the public finances. The resources must then be ring fenced. Whether one would earn a return on those funds in some way or another, and whether that was then returned to the fund or passed across to other parties—[*Interruption*.] I am sorry, something is beeping here.

The Convener: So much for my opening comment about mobile phones.

Professor Peat: It was a long time ago.

Professor Simpson: I thought that I had switched it off.

Professor Peat: It would have to be determined whether returns on the assets in the fund would be retained in the fund or transferred to the general budget. My preference would be that they be retained in the fund so that the fund would build up over time, but it would also have to be absolutely clear what the fund was to be used for.

John Mason: Thank you very much.

Professor Simpson's submission talks about "implicit debt" and "explicit debt". I am intrigued by that, because some of the figures seem to be quite high. What do you mean by implicit debt?

Professor Simpson: Implicit debt is all the spending commitments that a Government enters into for the future that are not covered by explicit taxes that have already been planned. The pensions promises for public sector workers are the most obvious example. It also covers things such as national health service funding. Not all NHS funding may be covered by the present tax revenues or tax revenues that are foreseeable on the basis of present tax arrangements. There are all sorts of other things, including legacy public-private partnership/private finance initiative liabilities and Network Rail expenditure.

Those liabilities tend to accumulate almost unseen, as it were. When we look at the debt position of any Government, we tend only to look back at the level of debt that has been accumulated in the past; we tend not to look forward and anticipate what the future liabilities might be that are calculable and which are in excess of foreseeable revenues.

John Mason: I certainly understand the point about PFI/PPP liabilities—that is real debt that will have to be paid—but I struggle with the idea of implicit debt associated with the NHS. Does the NHS not just live within whatever money is given to it? Any country that has more money can give a bit more to its health service, but if it has less, it will give the health service a bit less. Why is there a liability there?

Professor Simpson: I think that we all have expectations about the level of funding for the NHS, which relate to future commitments about levels of care. I am not sure that it is true to say that, if the foreseeable tax revenues failed to cover those commitments, we could just cut back on them at will. Even if we could, it would be wise to know about such potential cutbacks now, so that when they came along, they would not be unpleasant surprises.

John Mason: You suggest in your submission that the implicit debt could be more than five times the explicit debt.

Professor Simpson: That is what the American whom I mentioned in my submission calculated. He calculated the implicit debt not just for the UK, but for a number of other countries. He did not go into detail on his methods, but he is a perfectly respectable academic researcher, so I have no reason to dispute his numbers.

John Mason: The figures are certainly quite scary.

You went on to say:

> "The size of UK government debt, explicit and implicit, seldom appears to be the subject of serious debate at Westminster. A run on sterling could be precipitated at any time."

Is that overstating the case a bit?

Professor Simpson: No, it is not. We have been very lucky. A Conservative might say that we have not been lucky and that it is thanks to good policy that there has not been a run on sterling since the financial crisis broke. However, that is not to say that the issue is going away. If the present mini-boom in house prices continues, a significant rise in interest rates could well be triggered eventually, which might in turn trigger a downturn. Another downturn in the economy within two or three years could well trigger a run on sterling.

John Mason: Earlier in your submission, you use the phrase,

> "When interest rates return to a more normal level".

Do you feel that they are artificially low at the moment?

Professor Simpson: Absolutely—I think that everyone recognises that. The loose-money policy of quantitative easing has meant that interest rates are at unprecedented low levels. Everyone also agrees that that cannot go on for ever, because it would let loose uncontrollable inflation. I think that it has loosened quite a bit of inflation already. For example, the stock market has risen in the past few years because of the availability of money. I do not think that it would be safe to continue to do that. Indeed, the Federal Reserve and, to a lesser extent, the Bank of England have announced plans for tapering off the rate of increase in the money supply, which will inevitably raise interest rates to their more normal level.

John Mason: That is quite a bleak picture that suggests that the UK is not doing very well.

Professor Simpson: I am afraid that it is. Economists are fairly bleak people

John Mason: Do you share that view, Professor Peat?

Professor Peat: I certainly share the view that interest rates will rise, because they are at an artificially low level. However, I have no idea whether they will go back to 6, 7 or 8 per cent or stabilise at 2 to 3 per cent. I hope that we are in a relatively low inflation environment and that the level of interest rate that is required will therefore not be excessive. We must remember that any increase in interest rates places a very severe burden on households as well as on businesses. If rates were to rise rapidly, that would risk further debt problems of substance emerging, particularly in the household sector. The rise must be managed very carefully, which is why the Government and the Bank of England are looking to ease the pressure on the housing market as one way of avoiding unnecessary increases in interest rates. They want to achieve that by changing the policy on stimulating demand rather than changing interest rates directly.

On the question of implicit debt, I totally take David Simpson's point so far as PPP/PFI is concerned. Those are debts that are committed; they are not contingent liabilities but existing liabilities that should be included. However, I think that how one manages the position on the health sector, for example, is a somewhat different story. It is absolutely right that one should look at the implications over an extended period for the public finances if the health sector was given the funds required to maintain certain standards to take account of health inflation. We know that health costs rise more rapidly than costs in other sectors and that, with an ageing population, demographic change leads to high health costs.

It is absolutely right to look at the impact of that on the public finances, but I do not think that one can then automatically assume that that leads to an increase in debt. The Government of the day has the opportunity to determine whether it wishes to stick to commitments on health, pensions or whatever and whether it wishes to do so by reducing expenditure in other areas to compensate or by raising taxation to compensate. So, deficits can be adjusted to take account of the expenditure on health or pensions without that necessarily leading to a rampant increase in debt. There are therefore ways of managing policy. It is right to be aware of the risks, but one should not assume that every extra pound that is spent on health leads to an increase in debt—that does not follow as night follows day.

John Mason: That is helpful. One suggestion that we have had previously is that, traditionally, when countries are heavily indebted they quite like inflation because it erodes the value of the debt. Will that be a temptation for the UK going forward?

Professor Peat: I very much hope not. A significant increase in inflation will lead to a deterioration in the value of sterling and higher interest rates under the existing regime, which will lead to higher costs for business and a further rebound on inflation, as imported inflation rises and sterling falls. Having higher inflation may be a lovely way in principle of lowering the real value of the debt, but I do not think that it is a stable approach to solving the issue. Sound policies are much more appropriate.

Professor Simpson: I agree with what Jeremy Peat has just said.

John Mason: Professor Simpson, you say that an interest rate rise will put serious pressure on the UK's finances. If the UK debt stays the same or increases and the interest rates increase—as I think both witnesses suggest they will—that will put huge pressure on the UK. Will the UK not be tempted to go down the inflationary route?

Professor Simpson: Absolutely.

12:45

Professor Peat: I do not believe that it will be tempted to go down that route, because it would be such a change to the policy that was deemed to be successful in that glorious period in days gone by. All serious parties are committed to lower inflation and a stable environment into the future. It would be difficult to move away from that and I think that it would be wrong.

John Mason: Sticking to interest rates, we have talked a bit about how the interest rate for an independent Scotland would be different from the interest rate for the UK. There are a number of issues in there, such as the personnel who run the respective economies and the actual policies that would be involved. It has been suggested that, on the whole, smaller countries pay a premium, although we have also had evidence that some smaller countries are so well run that they actually end up with a lower net interest rate. Presumably, the debt level would be a factor because, if we have a huge debt, there will be a higher risk and if anyone lends us any more, it will be at a higher interest rate. Are those the main factors that need to be considered?

Professor Simpson: Again I come back to my point that it is not helpful to try to put numbers on these things. For example, at the height of the Irish debt crisis, they were having to borrow at something like 15 per cent over 10 years on the commercial market. Now, the Irish Government's 10-year borrowing rate is actually lower than that of the UK. I do not think for a moment that that will be a permanent situation, but it indicates that one ought to be careful about putting numbers on these things.

The first part of your question was about the difference between interest rates in Scotland and the rest of the UK. My response to that is: what interest rates, relating to what type of debt? On Government debt, any difference between the two would be due to the difference in the market's perception of the ability of each Government to repay its borrowing. It is not at all clear to me that that would necessarily favour the UK. As I just said, a week or two ago, the Irish Government's borrowing rate was lower than that of the UK.

On the other hand, if we talk about the more important kinds of borrowing, such as commercial borrowing for long-term investment, the markets will judge on the characteristics of the borrowing company and the prospects of the project. I do not think that they will be inclined to add any other factors to that.

John Mason: Can you explain why the Irish borrowing rate has recently been lower than that of the UK?

Professor Simpson: No, I cannot. It is just an indication of the way in which markets, especially international bond markets, can move in quite irrational ways, or at least in ways that are not immediately apparent to observers.

John Mason: On the second point, you suggested that Government borrowing is distinct from individual or business borrowing. Are the two rates not related at all?

Professor Simpson: I cannot see why business borrowing should have any particular negative premium—if that is what you are hinting at—attached to it simply because the business is located in Scotland.

John Mason: Do you want to comment on that, Professor Peat?

Professor Peat: My expectation is that the factors to which you referred are the main ones that will determine the differential on interest rates. Yes, some small economies have lower rates, but that is because they have achieved great credibility and have very conservative policies. Other things being equal, small countries tend to have a small margin, and Scotland would have to gain credibility over time.

There is also an issue around the stability of the currency. If Scotland were borrowing in sterling as part of a currency union, the markets would have to be satisfied that that was likely to be sustained for an extended period before they placed a premium. As far as corporate borrowing is concerned, I always thought that there tended to be a margin over the London interbank offered rate—or whatever the base rate is within an economy—that led to the costs of borrowing. If the rate of Government borrowing was slightly higher here than elsewhere, I would think that that might feed through to an equal small margin for those borrowing in the corporate sector. However, the main issue would be the security of the company and the way in which it was reflected in the markets.

John Mason: Okay—thank you very much.

The Convener: It has been a long evidence-taking session and we could discuss many things that I was keen to go into, such as economic growth and productivity, but we do not have time for that, so I will finish with a final question.

The point of the inquiry is to discuss Scotland's public finances post-2014. We have talked a lot about what will happen if there is a yes vote and we have already mentioned that there does not seem to be a lowest common denominator in the unionist parties' policies for what will happen if there is a no vote.

If there is a no vote, it is likely that, in the next two or three years, UK parties will focus very much on the UK general election and possibly, depending on the outcome of that election, a European referendum. Is there likely to be any real focus on Scotland—for example, we have heard about the Barnett formula potentially being reviewed—or will Scotland be lost in all of that? If Scotland is not to be lost and we have further devolution, what one fiscal power would be your priority to devolve to the Parliament?

Professor Simpson: To answer your last question, VAT is the most important single tax that should be devolved.

I do not believe that the unionist parties would have the slightest interest in introducing any substantial additional devolution legislation. If we look at the period after the 1979 devolution referendum, which was lost, we see that nothing was done for another 20 years.

Put yourself in the position of the party managers of the Conservatives and the Labour Party in London. Why on earth should they introduce any further devolution? What is there to be gained by introducing legislation concerning Scottish devolution when much more important issues are at stake? Therefore, I cannot envisage any movement at all. That is reflected in the carefully judged vagueness of such commitments as have already been made. They are notable for their lack of clarity. I think that the answer is that nothing will happen.

Professor Peat: I hope that David Simpson is wrong. I hope that, in the event of a no vote—particularly if it is a close no vote—attention will be focused on the next round of devolution, particularly fiscal devolution.

That may be associated with a call for follow-up on needs assessment. You talked about revising the Barnett formula, convener. I think that pressure will come from Wales and elsewhere for a reconsideration of the way in which that formula works in the context of a needs assessment study. Gavin McCrone has talked to you about that.

Needs assessment is complicated. When I was at the Scottish Office, I got involved in a mock needs assessment, from which I learned that I could probably have come out with whatever conclusion people wanted from the analysis. However, an assessment would potentially be on the table, because there is a view that Scotland has done relatively well and Wales has done relatively badly. In the context of a no vote and consideration of further devolution, that might come to the fore.

On what I would seek to devolve, transferring responsibility for significant further parts of welfare would give real opportunities to make decisions in Scotland. Devolving further income tax would not lead to major changes. If the Scottish Government was more able to make its own decisions across a wide range of welfare policies, it might give an opportunity for Scotland to develop its own priorities and implement policies in that context. Gavin McCrone touched on that in his evidence and gave fairly clear indications of where it could go.

The Convener: That is assuming that the resources would be devolved with those powers. When council tax benefit was devolved, the resources were reduced by 10 per cent—it cost us £40 million a year—and the bedroom tax is going the same way.

Professor Peat: Absolutely. You are entirely right. A full, appropriate resource would have to be transferred and there would have to be careful scrutiny to ensure that that sum was forthcoming.

The Convener: Our two guests have been tremendous in answering all our questions. Do they have any further points that they wish to make?

Professor Peat: I am done.

The Convener: Thank you very much for that.

For three long years, my loyal—nay, devoted—deputy convener has been champing at the bit to chair the Finance Committee and, next week, he will have that opportunity.

On that positive note, I close the meeting.

Meeting closed at 12:55.

Members who would like a printed copy of the *Official Report* to be forwarded to them should give notice to SPICe.

Available in e-format only. Printed Scottish Parliament documentation is published in Edinburgh by APS Group Scotland.

All documents are available on
the Scottish Parliament website at:

www.scottish.parliament.uk

For details of documents available to
order in hard copy format, please contact:
APS Scottish Parliament Publications on 0131 629 9941.

For information on the Scottish Parliament contact
Public Information on:

Telephone: 0131 348 5000
Textphone: 0800 092 7100
Email: sp.info@scottish.parliament.uk

e-format first available
ISBN 978-1-78457-432-1

Revised e-format available
ISBN 978-1-78457-444-4

Printed in Scotland by APS Group Scotland