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Scottish independence:

Walking the road to 2014 – the practical implications of separation

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1. Introduction

"We don't shy away from putting facts and evidence before the Scottish people. We want you to scrutinise, challenge and form your own opinion."

UK Prime Minister David Cameron, 10 February 2013

On 15 October 2012, UK Prime Minister David Cameron, Scotland's First Minister Alex Salmond, UK Scottish Secretary Michael Moore and Scotland's Deputy First Minister Nicola Sturgeon signed an historic agreement granting the Scottish Government the legal powers to hold a referendum on the 300 year-old Union with the United Kingdom.

The provisions of the Edinburgh Agreement set out that the Scottish Government would have the authority to hold a single-question referendum on the issue of independence before the end of 2014. In addition, the Agreement also set out that the Electoral Commission would oversee the referendum, in addition to providing advice on the wording of the question and campaign finance.

Following this, the terms required the approval of both the Westminster and Scottish Parliaments, in the form of a Section 30 Order of the Scotland Act, or Section 30 Order. On 15 January 2013, the Order was passed by the House of Commons and by the House of Lords the next day.

The next hurdle for the referendum came on 30 January 2013, when the Electoral Commission published its advice on the wording of the referendum question and limits for campaign finance. The Scottish Parliament subsequently accepted all of the Commission's suggestions.

In the following weeks, the Scottish Government sought to flesh out greater detail of the referendum process on 5 February, explaining that Scotland could become independent within 15 months of a 'Yes' vote.

At the time of writing, the Scottish Government was expected to bring forward the final details of the referendum, including the specific date of the poll, in a Bill to be put before Holyrood in March.

However, whilst we know the broad strokes of the constitutional debate, questions remain over many of the practical consequences of independence. The Scottish Social Attitudes Survey, published in January, revealed that only one in four respondents supported independence, the lowest level since 1999. In response, a Scottish Government spokesperson was quoted by the *Daily Record* newspaper as saying:

"We have already set out our vision for the country we would like Scotland to be... During this year the Scottish Government will outline the compelling case for independence, leading to a white paper in the autumn that will set out the Government's proposals for how that independent Scotland will look."

However, the debate will not remain static until the publication of the White Paper in autumn 2013. Both the UK and Scottish Governments have sought to set out likely implications and options for voters in the referendum.

Last summer, UK Scottish Secretary Michael Moore announced the UK Government would be publishing a series of analysis papers on the political, constitutional and economic implications of independence. The first paper in this series was published on 11 February 2013.

Alongside the paper, Mr Moore published a legal opinion from James Crawford SC, Professor of International Law at the University of Cambridge, and Alan Boyle, Professor of Public International Law at the University of Edinburgh. Whilst it acknowledged that the exact status of an independent Scotland and the remainder of the UK (rUK) would depend on negotiations between the two countries, there were a number of possible legal outcome.

One of these was that:

"Most likely, the rUK would be considered the continuator of the UK for all international purposes and Scotland a new state... The fact that the rUK would retain most of the UK's territory and population and that its governmental institutions would continue uninterrupted would count in its favour. So, importantly, would the acquiescence of other states in any claim of continuity. Since the rUK would be the same state as the UK, questions of state succession would arise only for Scotland."

It was this opinion that was seized on by the UK Government to inform its analysis series, as Mr Moore confirmed at the paper's launch:

"Our paper is informed by expert opinion from two leading authorities on state formation and how this is seen in international law... What this legal opinion makes clear is that legally and constitutionally, leaving the UK would have serious repercussions which would affect all of us in Scotland."

The same day, the Scottish Government published the Fiscal Commission Working Group (FCWG) report on a likely macroeconomic framework for an independent Scotland. Set up by First Minister Alex Salmond in March 2012 and chaired by Crawford Beveridge CBE, the Commission includes Professors Andrew Hughes Hallett, Sir Jim Mirrlees, Frances Ruane and Joseph Stiglitz to provide impartial economic advice for a post-independence Scotland.

With the publication of these papers, the debate around Scottish independence has shifted firmly from the constitutional to the practical, and it marks a start of a race to inform the public.

In this briefing, DeHavilland focuses on the practical recommendations and opinions on the possible implications of independence, rather than constitutional or legal ones. This briefing focuses particular attention on the overall structure of the Scottish economy, with a particular focus on the prominent role of the energy and financial services sectors, as well as proposals for the structure of monetary and fiscal policy.

2. The Fiscal Commission Working Group – First Report – Macroeconomic Framework

Background

The Fiscal Commission Working Group (FCWG) is a sub-group of the Scottish Government's Council of Economic Advisers, which is tasked with "helping to shape the development of a robust fiscal and macroeconomic framework for an independent Scotland."

The FCWG consists of Professors Andrew Hughes-Hallett, Sir Jim Mirrlees, Frances Ruane and Joseph Stiglitz, and was chaired by Crawford Beveridge CBE.

Established by First Minister Alex Salmond in March 2012, the FCWG published its first report on recommendations of the macroeconomic framework for an independent Scotland on 11 February 2013.

DeHavilland has focused its assessment on the report's overview of the Scottish economy, its analysis of its performance and evaluation of certain key sectors, specifically energy and financial services.

The Scottish economy – summary

In assessing the overall structure of the Scottish economy, the report highlights that many of Scotland's economic indicators are in line with that of the UK average. However, significant exceptions included:

- GVA per capita (£20, 571) is 99 per cent of the UK average—highest outside London and the South East
- For the 30 years prior to 2008, average growth per annum was estimated at 0.5 per cent lower than the UK average
- Scottish onshore GDP accounted for £124 billion (8.2 per cent of the UK total)
- Including North Sea output increases the economy by 20 per cent, to 115 per cent of the UK average (9.9 per cent UK total)

The report states that while there is "no obvious characteristic that explains this underperformance", independence would allow Scotland to "escape the limitations of the current constitutional framework", better unlocking its potential and giving it scope to utilise the "full spectrum of policy levers to perform more successfully across a range of social and economic indicators" that other countries have been able to.

Like the UK as a whole, Scotland performs poorly on inequality indicators.

Scotland's population and economy size is comparable to that of other advanced economies (as defined by the IMF); of the 34 advanced economies, 10 have populations less than Scotland.

Employment and unemployment rates (7.8 per cent) are similar to the rest of the UK (7.7 per cent).

Workplace earnings are slightly lower in Scotland, with median gross annual earnings being 2.4 per cent lower than the UK as a whole. This is argued to be due to London inflating the UK value.

Price levels are also similar, with Scotland being 99 per cent of the UK average (with London as an outlier).

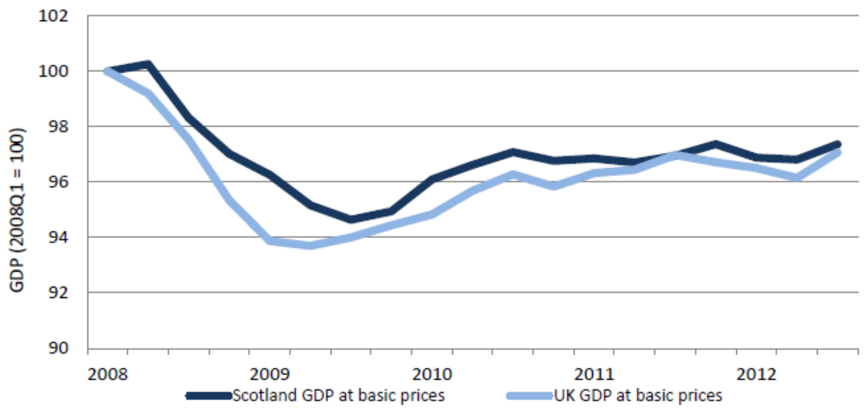
The UK as a whole is argued to be more susceptible to house price bubbles and fluctuations, with the report implying isolation from this as a benefit of independence.

Economic growth

The report acknowledges that accurate assessments of independence's effects on growth are difficult and dependent upon a variety of factors.

Notably, again, there is an accepted level of underperformance within the Scottish economy. This, it is argued, is in part due to labour productivity being (along with the UK) "less favourable" compared with similar countries.

Chart 4.04: Scottish and UK performance over Recession



Source: Scottish Government, ONS

Future population growth (in part fuelled by migration from both within and outside of the EU) is argued to be a strong indicator of a future boost to economic growth. It is in this area of population growth and dynamics that Scotland is suggested to be of significant difference to the UK. As a result, the report argues that the prospect of independence opens up the potential for significant economic gains gains to be made.

Scotland's dependency ratio is currently lower than the UK but by 2026 it is estimated to increase more rapidly, eventually arriving at a slightly higher rate than the UK as a whole.

Inequality

The Scottish Government's *Government Economic Strategy* recognises that certain characteristics of growth that relate to inequality and sustainability are "just as important" as growth itself.

However, the FCWG says that Scotland and the wider UK both perform poorly relative to other OECD estimates. Greater access to policy levers (e.g. taxation and welfare policy) would, it argues, allow the Scottish Government to address these trends more efficiently.

Structure of the Scottish economy

As with other advanced economies, the Scottish economy has seen a trend in switching from manufacturing to services. The service sector currently accounts for 72 per cent of total output and 81 per cent of employment. The structure is “broadly similar” to the UK; Scotland has a higher share of Government and Other Services (25.7 per cent vs. 23.3 per cent) and a lower share of Business Services and Finance (25.4 per cent vs. 29.1 per cent).

There are some key differences within sectors (e.g. oil and gas) are of greater importance in Scotland. In addition, there is a “relatively high proportion of total UK activity in diverse sectors from fishing to life insurance located in Scotland”.

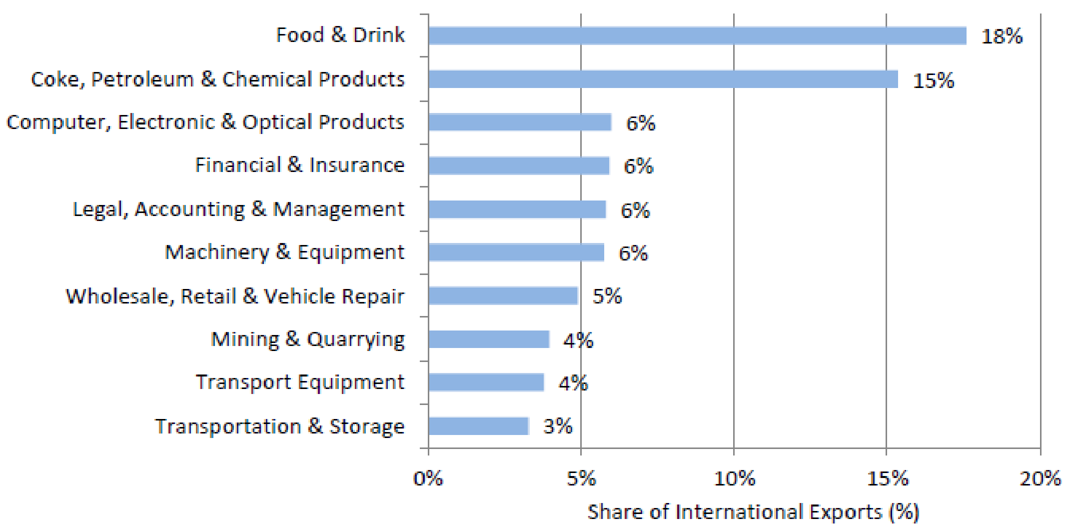
Business base and openness to trade

Scotland has a relatively smaller business base, lower business start-up rates and lower levels of business expenditure on research and development than the wider UK. However, the significance of large companies in the Scottish economy is greater than for the UK as a whole. Business Enterprise Research and Development (BERD) in Scotland is concentrated among a small number of companies: the top five account for over a fifth of Scottish research and development (R&D) employment.

In terms of gross expenditure on research and development, the report claims that Scotland “performs better,” due to the strength of the Scottish university sector.

In 2011 International exports (excluding oil and gas) were estimated to be worth around £23.9 billion. The EU was Scotland’s main trading partner, with 46 per cent of all its international exports in 2011. Two thirds of its total exports (£45.5 billion) were with the rest of the UK. Scottish exporters enjoy a comparative advantage in high value sectors such as electrical engineering, financial services and niche products, such as whisky.

Chart 4.16: Top 10 International Exports by Sector, 2011



Source: Global Connections Survey, Scottish Government

3. Energy

Scotland's oil and gas reserves also would make a significant contribution to the Scottish economy post-independence. In their 2012 Economic Report, Oil and Gas UK estimated that in 2011/12 North Sea oil and gas exports boosted the UK's balance of payments by £40 billion. The vast majority of these reserves came from Scottish waters. It has been estimated that there could be as many as 24 billion barrels of oil equivalence remaining in the North Sea.

Additionally, Scotland accounts for 45 per cent of employment in the UK oil and gas industry. However, in the same report, Oil and Gas UK pointed out that the majority of the jobs rested in the rest of the UK, saying "these figures confirm that the industry is not simply Aberdeen-centric and the benefits of the industry, in terms of employment, are widespread."

For 2010/11, Scotland's geographic share of revenue from offshore oil and gas was estimated to be £8 billion. However, the report noted a decline in North Sea revenues between 2008/9 and 2009/10 from £12.9 billion to £6.5 billion. It commented "North Sea receipts have historically been more volatile than onshore tax revenue... the fiscal rules of an independent Scotland will have to reflect the need to carefully manage this windfall to ensure that the benefit it brings to the Scottish economy is maximised."

Moreover, the Fiscal Commission Working Group saw "clear merit" in proposals by the Scottish Government to invest a proportion of oil and gas revenue into an Oil Fund for future generations.

In addition, Scotland has been estimated to have around 25 per cent of Europe's potential offshore wind and tidal energy, 10 per cent of Europe's potential wave power and an estimated 50 per cent of carbon capture and storage reserves.

In 2010, First Minister Alex Salmond set the ambitious target that Scotland could generate all its electricity from green sources by 2025. However, in February 2013, the *Guardian* reported that Mr Salmond could be forced to abandon this target.

The report 'Delivering Renewable Energy Under Devolution', argued that an independent Scotland would have to fund far more of the billions needed to subsidise renewable energy such as offshore windfarms and wave and tidal devices on its own, because it would lose significant financial support from consumers across the UK, according to the article.

In answer to a parliamentary question from SNP Convenor of the Rural Affairs, Climate Change and Environment Committee Rob Gibson on 10 January 2013, Mr Salmond said "a clean, green energy supply based on renewables is a key part of a strategy for sustainable economic growth."

On 29 January, Mr Salmond went further setting a target for Scotland to cut its carbon emission by 80 per cent by 2030, through a greater reliance on renewables. In addition, the Scottish Government also published the report 'Scotland's Offshore Wind Route Map - Developing Scotland's Offshore Wind Industry to 2020 and Beyond.'

Any doubt cast upon this claim would cast a pall over an independent Scotland's claims to macroeconomic credibility.

4. Monetary policy

Financial services

The FCWG identifies financial services as one of "niche products" in which "Scottish exporters tend to find comparative advantage".

Overall, Scotland made up around 8.1 per cent of employment in UK financial services in 2011. However, Working Group identifies a particular concentration in life products and pensions (28.5 per cent of UK industry employment, according to the Business Register and Employment Survey) and the growth Scotland had been enjoying in the asset management sector (an increase of 13,500 in 2010 to 15,600 in 2011).

A significant note is report's claim that "in reality a future UK Government and central bank post-independence would have a major self-interest in the adequacy of supervisory arrangements for institutions based in Scotland and operating in the UK, and vice versa." It argues that this interdependence reinforces the important of maintaining a "stable, integrated and well-function financial system across both countries."

To this end, it advocates close co-ordination financial stability policy post-independence.

Monetary union

The headline recommendations of the FCWG report centre on the retention of Sterling as the currency of an independent Scotland, through its entry into a formal monetary union with the rest of the UK.

Retaining the Pound would prove a useful mechanism for the transition to independence, because it would give new political and economic institutions time to establish credibility and develop institutional capacity, the reports claims. It also highlights the possibility that such a policy could provide stability to resolve any negotiations on public debt, give lenders certainty on repayments and stable conditions for investment in the Scottish economy.

The FCWG vision for a monetary union between two independent nations rests on an integrated financial system with elements of a banking union including aligned prudential supervision and clear procedures for crisis management. The Bank of England would remain the central bank responsible for day-to-day monetary policy. However, interest rates would be set to promote stability across the 'Sterling zone', and the Scottish Government would have a formal input into the governance of the Bank, including representation on key committees, such as the Monetary Policy Committee.

However, the UK Government has set out a different view of an independent Scotland's relationship with the Bank (see below).

Bank of England

In its first analysis paper 'Scotland analysis: Devolution and the implication of Scottish independence', published on 11 February 2013, the UK Government set out its view on the relationship an independent Scotland would have with the existing institutions in the remainder of the UK, including the Bank of England.

In contrast to the vision set out by the FCWG, the UK Government argued that the Bank's functions and objectives would cease to apply to Scotland in the event of independence.

Whilst acknowledging the Scottish Government's desire to retain the Bank as its central bank, the paper remarks that any bid "to make use of arrangements now operative within the UK should they so wish, although any proposals would need to be considered carefully and may not be straightforward or necessarily in the interests of the continuing UK."

It is significant to understand that whilst the FCWG acknowledges that "the Bank of England is being given a stronger role in financial stability" under the Financial Services Act 2012, they also argue it would be a benefit to supervision and oversight in "ensuring a degree of consistency given the broadly integrated financial services sector (both within the UK and increasingly Europe)". Therefore opportunities for a "different and distinct" approach to financial oversight would be "likely to be constrained and of limited benefit."

The role of the Bank of England in an independent Scotland was a central theme of last year's inquiry by the Lords Economic Affairs Committee into the 'Economic Implications for the United Kingdom of Scottish Independence'. Although no witness from the Bank gave evidence to the inquiry, the Committee did question former Deputy Governor Sir John Gieve.

Questioned by the Committee on the Bank's role in an independent Scotland, Sir John said:

"When Scotland becomes independent, the Bank of England remains the bank of the United Kingdom and is subject to Westminster law and the Westminster Government. The decision, if you like, on how far Scotland continued to use or have access to the central bank would be an issue for the [UK] Government ... to some degree."

At the time of writing, the Committee's final report is expected to be published in mid-March.

However, in light of Sir John's opinion on the influence of the UK Government on the issue, the stated opposition to an independent Scotland having an automatic role in the Bank means this will remain a contentious issue.

Crisis management, resolution and deposit protection

The context of the recent financial crisis has focused discussion on the ability of an independent Scotland to cope with a repeat of a similar event.

This significance was underlined by evidence given by RBS Chair Sir Philip Hampton to the Lords Economic Affairs Committee on 13 November 2012:

"...lender of last resort facilities are essential for a bank to have available. I do not know, sitting here at the moment, what arrangements might be put in place in the event of an independent Scotland within some sort of currency union... From the point of view of RBS, it would be important to know that we had appropriate lender of last resort facilities for our operations."

Seeking to address such concerns, the FCWG sets out possibilities, including an arrangement built on the Banking Act 2009, based on the current integration of UK financial services and direction of international cooperation on issues, because "the design a framework should reflect this shared interest in financial stability".

On deposit protection, the report floats the suggestion of Scotland seeking “arrangements that allow the continuation of a shared scheme across the Sterling Zone” in order to “place a lower administrative burden on financial institutions”.

Significantly, whilst describing any joint scheme as “attractive”, it leaves open the possibility of an independent Scotland establishing its own scheme without threatening current arrangements.

5. Fiscal policy

Greater fiscal autonomy for Scotland remains a curious element of the independence debate in that there is arguably considerable common ground between the 'Yes' and 'No' campaigns.

In 2009, the Scottish Government published the paper, 'Fiscal Autonomy in Scotland: The case for change and options for reform.' Whilst it unsurprisingly extolled independence as the "best way forward", it did acknowledge "there is now a growing consensus on the urgent need to enhance the taxation, spending and borrowing responsibilities of the Scottish Parliament."

This consensus reached fruition in the form of the Scotland Act 2012. It introduced a new Scottish rate of income tax, borrowing powers worth £5bn, in addition to the devolution of stamp duty, land tax and landfill tax, after 2016.

Whilst the Coalition Government trumpeted it as the biggest transfer of fiscal power to Scotland in more than 300 years, it also has two significant outcomes for the debate on independence.

Firstly, it presented a hint of how any post-independence negotiations between the UK and Scottish Government could be conducted. Despite lengthy wrangling between the two parties, an equitable solution was eventually reached.

Secondly, and more significantly, the Act also deprived the SNP of the capacity to exercise important levers of fiscal policy in the run-up to the autumn 2014. Whilst the ability to use said abilities would be a two-edged sword, nonetheless, effective wielding of the measures contained in the Act would have allowed the Scottish Government to slay many of the questions that remain about its aptitude to raise and spend as a separate, self-governing entity.

As it is, this area of the referendum debate has been consigned to speculation.

In November 2012, the Institute for Fiscal Studies (IFS) published its briefing 'Scottish independence: the fiscal context.' Among its assessment on the long term issues and likely fiscal architecture post-independence, the IFS estimated Scotland would inherit a share of UK national debt of at least two thirds of its national income. The Scottish Government would need to decide if an independent arbiter would be needed for fiscal rules, like the Office for Budget Responsibility (OBR). Crucially, it suggested that the new state would need to look for a budget balance without volatile revenues from oil and gas.

Mostly importantly, it concluded "an independent Scotland would face some tough long term choices in the face of spending pressures created by demographic change. If, as is likely, oil and gas revenues fall over the long run then the fiscal challenge facing Scotland will be greater than facing the UK."

The FCWG also acknowledges this core concern and identifies that a major challenge for an independent Scotland would be to diversify its tax income. However, issues of demography are dismissed on the grounds that that independence would mean that Scotland would have "greater flexibility to respond to these pressures than it currently does as part of the UK."

It also agrees that Scotland would inherit a share of UK national debt, but emphasises that the nation would seek a "fair and equitable" share alongside a share of assets. However, even a division of debt on a per capita basis would still leave it with a large level by historical and independence.

However, in spite of these concessions, the Working Group returns to the explanation of independence as the cure, , because “with access to the full range of fiscal levers, policy makers could take advantage of the synergies that cannot currently be achieved when some aspects of policy are determined at the UK level”.

However, in the end, the implications of an independent Scotland’s fiscal policy could be impossible to discern until they have to be tested, as IFS Director Paul Johnson suggested to the Economic Affairs Committee on 27 November 2012:

“The key advantages and disadvantages may come from the economics, but they are much more likely to come from the choices.”

6. Conclusion and reaction

As was remarked in the introduction, the publication of these papers marks a shift in the emphasis from the independence debate from the abstract to the practical. In doing so, they have revealed what is at stake for each side in the referendum.

Both the UK and Scottish Governments have begun a series of publications, but from different standpoints. Westminster seeks to use the advantage of incumbency, bringing forward a series of topical analyses from across Whitehall. In contrast, the Scottish Government wishes to build up its credibility by leading with analyses produced by an independent group of reputable economists.

At the time of writing, both sides were expecting progress on the back of their respective reports. In an appearance before the Scottish Affairs Committee on 13 February, Scottish Secretary Michael Moore confirmed that the next paper in the UK Government's series would focus on currency and would be published in the next few weeks. Meanwhile, the Scottish Government confirmed to DeHavilland that whilst the FCWG had not decided on the next topic, they had been examining economic regulation and taxation systems.

The significance of these first two lies in the fact that they have framed the independence debate for the next year and a half, and perhaps beyond. Westminster will seek to present a case that an independent Scotland would be isolated and weakened by separation from the UK. Meanwhile, the SNP will naturally seek to refute this.

A poll conducted by Ipsos MORI in the run-up to the publications and published on 13 February found that support for independence had risen from 30 per cent in October 2012 to 34 per cent, whilst support for the Union had fallen by 3 per cent. Most significantly, 11 per cent of voters listed themselves as undecided.

However, a more significant test of the referendum debate came from students at Glasgow University. The University's Dialectic Society ran a mock referendum among students, using the referendum question, "Should Scotland be an independent country?" 63 per cent of the students voted against independence, compared to just 37 per cent in favour.

Nevertheless, the economic and fiscal condition of the United Kingdom will provide an interesting context for the referendum. On 22 February 2013, the Moody's ratings agency downgraded the UK's AAA credit rating to AA1. Writing following the decision, BBC Scotland Business and Economy Editor Douglas Fraser wrote, "At least the SNP can enjoy the tarnishing of the United Kingdom's highly-valued triple-A credibility. The appeal to Scots of sticking with the union doesn't look so attractive, if Moody's is any guide."

It is testament to their awareness of the credibility deficit that the Scottish Government published their paper, 'Economic and Competition Regulation in an Independent Scotland' on 28 February 2013. Launching the 24 page document, Finance Secretary John Swinney said independence would bring simpler regulation, with one or two bodies overseeing economic and competition authorities.

It sets out two worked examples for how this might be achieved.

The first is a single body that brings together the functions of the Office for Fair Trading (OFT) and the Competition Commission in the energy, telecommunications, postal services, water and rail sectors. In the second, it is a combined utility regulator with a separate competition authority with the former retaining regulatory powers, but the latter carrying out the functions of the OFT and Competition Commission in Scotland.

This would be in contrast to the six bodies the UK Government currently has. The regulation of the financial services sector and the oil and gas sector are expected to be addressed in future papers.

The paper also sets out a vision for the regulation of broadband in a devolved Scotland focused the needs of the economy, businesses, and users, whilst highlighting Scotland's effective record of economic regulation through its one devolved body, the Water Industry Commission for Scotland (WICS).

Nonetheless, the majority still heavily supports the pro-union campaign, but with perhaps 18 months until polling day, the only currency both sides will be interested in is credibility with the Scottish electorate.