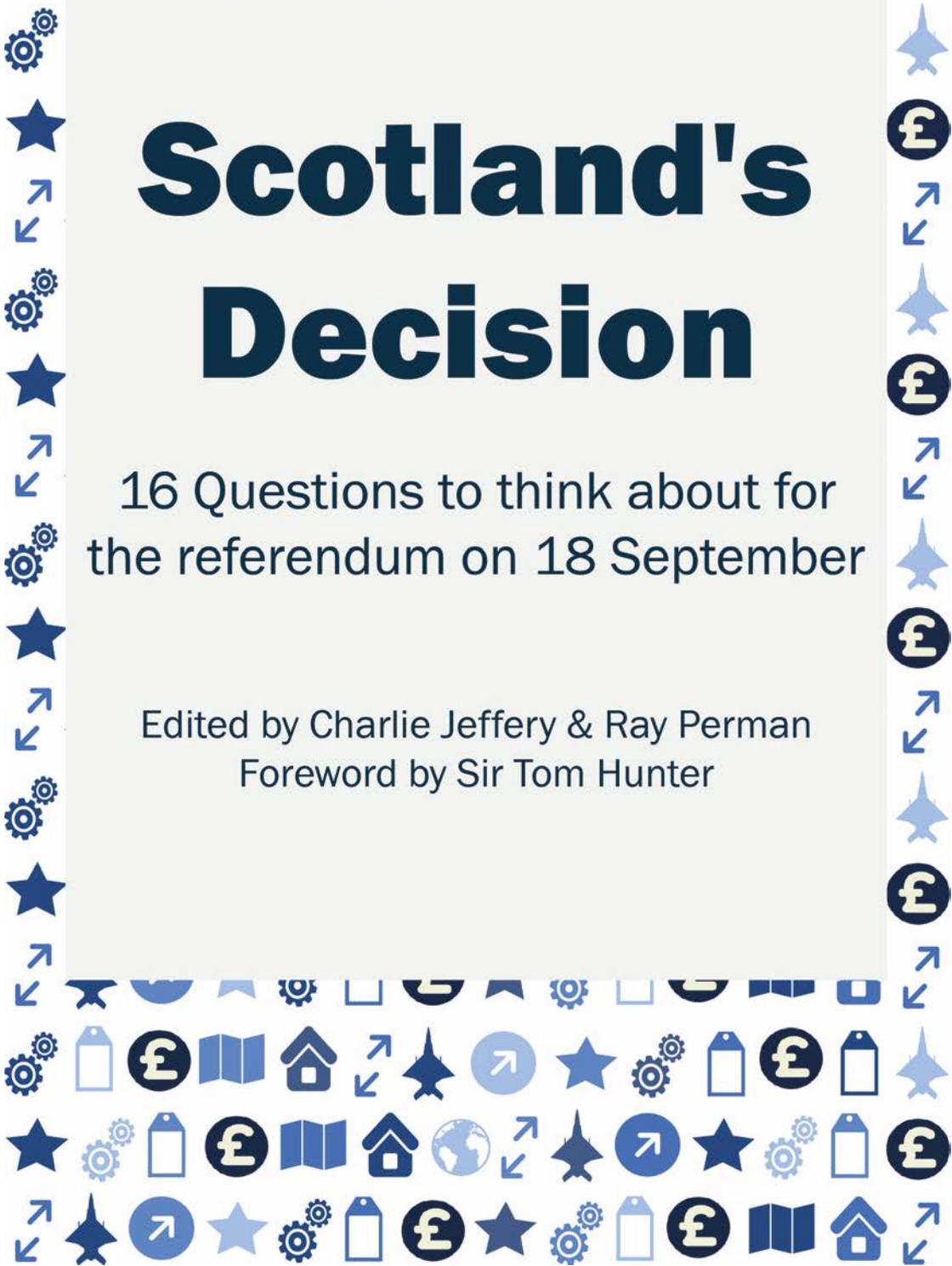




Scotland's Decision

16 Questions to think about for
the referendum on 18 September

Edited by Charlie Jeffery & Ray Perman
Foreword by Sir Tom Hunter



Scotland's decision

Should Scotland be an independent country? Choosing an answer to that question, as Scotland's electors will on 18 September 2014, is a choice of huge significance. So how will we come to a decision?

Many voters know more or less by instinct. Plenty of us are convinced that being independent is right and good for our country and not being independent is wrong. Plenty of others believe the opposite: that what is right and good is staying as part of the UK. But there are more still – probably the biggest single group – who don't have such conviction either way and are puzzling their way through what voting Yes or No might mean for them and their families.

This book is for them. We have taken sixteen questions, which seem to us to be central to the referendum debate, and asked impartial experts to look at them. We do not aim to provide definitive answers – and we certainly do not intend to tell anyone how to vote – but rather to enable readers to better judge the claims that are made by either side.

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The David Hume Institute
Promoting informed debate on public policy



The Hunter Foundation

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Foreword

Sir Tom Hunter, philanthropist and entrepreneur

Scotland's biggest decision in over 300 years for us, our children and our children's, children is almost upon us; that decision will be irreversible. Like many voters, I am genuinely undecided. I want to make the best choice I can for myself, my family and for Scotland, but I don't feel that the campaigns so far have given me the facts and unbiased assessment to make a properly informed decision. I know I am not alone in thinking this way.

A recent poll commissioned by the Hunter Foundation and published in early July showed 56% of undecided voters simply don't feel they have enough impartial information to make a decision. And 45% of all voters claim they don't trust either the UK or the Scottish Government's predictions. This is deeply worrying and also a sad indictment on the debate to date. This series of papers we hope will bring some light upon the critical issues voters may wish to consider in making up their minds when they put a cross on the ballot paper on September 18.

The academics who have researched these topics hold no side in the debate, have provided an impartial account of what is on offer from the Yes and No camps and their own non-partisan assessment. Will these help us make up our minds? We hope so, but what they won't do is try to persuade us of either argument. As electors we alone have that responsibility and only we can decide how we will vote.

As the politicians continue with argument and counter argument it's easy for voters to turn off, but that would be the biggest tragedy of all for Scotland. Scotland's future is not in political hands its in the hands of this great nation's people. Whatever we choose, the day after the referendum will be a day when we must unite around our common future – but for now we need to choose carefully what that future will be.

Good luck.

Tom

Introduction

‘A wise person proportions his/her belief to the evidence.’¹

Charlie Jeffery and Ray Perman

Should Scotland be an independent country? Choosing an answer to that question, as Scotland’s electors will on 18 September 2014, is a choice of huge significance. So how will we come to a decision?

Many voters know more or less by instinct. Plenty of us are convinced that being independent is right and good for our country and not being independent is wrong. Plenty of others believe the opposite: that what is right and good is staying as part of the UK. But there are more still – probably the biggest single group – who don’t have such conviction either way and are puzzling their way through what voting Yes or No might mean for them and their families.

This book is for them. We have taken sixteen questions, which seem to us to be central to the referendum debate, and asked impartial experts to look at them. We do not aim to provide definitive answers – and we certainly do not intend to tell anyone how to vote – but rather to enable readers to better judge the claims that are made by either side.

One of our aims is to provide a clear summary of what each side has said on particular questions. The UK Government and the Scottish Government have each published well over a thousand pages of what they see as the problems and advantages of the status quo versus those of independence. The Yes Scotland and Better Together (No) campaigns have also put out swathes of information, largely online. Many other organisations, aligned with one side or another and plenty more which take neither side have added their views. Academics too, including those writing here, have had their say.

How much of this information has reached and influenced ordinary voters is less clear. That’s partly because few have the time or inclination to trawl through long documents. It’s partly because people hear contradictory things and tend to trust the claims of neither side as a result.

So our other main aim is to explain why the claims of the two sides are contradictory. Some of the contradictions are just straightforward politics. Each side wants to win and will do what it can to undermine the case of the other side in order to do so. It would be unrealistic to expect otherwise, but the result for voters is often confusion and, for some, disillusionment.

However, there is often more to it than just a tactical tit for tat. Each side views the question ‘should Scotland be an independent country’ through a different lens and so what they each mean by Yes and No is not the same.

The UK Government for example understands independence for Scotland in much the same way as it does the UK’s relationship with the European Union. It is about having the maximum level of national control over political and economic life that is possible and not, for example, about sharing a currency with another country.

The Scottish Government has developed a different understanding of

¹ Adapted from David Hume, *An Enquiry Concerning Human Understanding*

independence which is open to *sharing* control of important parts of political and economic life with others, whether the rest of the UK – for example its currency – or the EU.

To a good degree these are the differences of approach of a big, powerful country used to a leading international role and a small, would-be country which would pursue its interests through co-operation with others. Big countries and small countries – not just in the Scottish debate – often view their role in the world in quite different ways. So the two sides in the Scottish debate often end up talking past each other when apparently talking about the same thing, whether it is currency union, border controls, defence or many other matters.

The contradictions in the claims of the two sides are sometimes more technical. For example, when it comes to forecasting the economic implications of independence it matters hugely what assumptions you start with. Very different figures are produced if different projections of oil revenues, or of labour productivity, or immigration are used.

We saw this when the UK Government claimed Scots would be £1,400 better off if they stayed in the UK, and – on the same day – the Scottish Government claimed that Scots would be £1,000 better off with independence. Each used different starting assumptions favourable to its own case, so each produced different answers. There is probably only one certainty in all this, and that is that the forecasts of both sides will prove inaccurate.

The contributions in this book do their best to make clear the different assumptions each side makes, whether about what independence means or about how the Scottish economy works. We review what independent academic analysis makes of these differences in assumptions. And in that way we hope to help readers to make sense of what the two sides say and to come to their own judgements about which side has the most plausible set of claims on the sixteen issues we examine.

We have carefully selected our contributors to be impartial. They are, of course, entitled to their private views, but none has a declared interest on either side of the debate. This does not mean that they simply sit on the fence. It means they use their academic training to set out, discuss and evaluate the claims of each side. Their impartiality is in their approach. Some of their conclusions may lean more towards one side or the other. But that is a product of the results of their research and the way they do their analysis – and, in the end, of the strength or weakness of the arguments made by the two sides in the referendum debate.

August 2014

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Infographic: The road to the referendum

ON THURSDAY
18
SEPTEMBER 2014

voters in Scotland will be asked:
**Should Scotland be an
INDEPENDENT
COUNTRY?**

EDINBURGH AGREEMENT

THE EDINBURGH AGREEMENT BETWEEN THE UK AND SCOTTISH GOVERNMENTS STIPULATED THAT THE POLL:

Has a clear legal base.	Be legislated for by the Scottish Parliament.	Be conducted so as to command the confidence of parliaments, governments and people.
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Deliver a fair test and a decisive expression of the views of people in Scotland and a result that everyone will respect.

WHO CAN VOTE?

 UK CITIZENS RESIDENT IN SCOTLAND AGED 16 OR OLDER ON THE DAY OF THE VOTE	 EUROPEAN UNION OR QUALIFYING COMMONWEALTH CITIZENS RESIDENT IN SCOTLAND	 GOVERNMENT AND ARMED SERVICES PERSONNEL STATIONED OVERSEAS BUT REGISTERED TO VOTE IN SCOTLAND
--	--	--



Official campaigning begins



NO

Better Together is campaigning for a no vote, made up of representatives from Labour, Conservatives, and Lib Dems.

YES

Yes Scotland is campaigning for a yes vote, made up of representatives from the Scottish National Party and the Scottish Greens.

YES and NO CAMPAIGN SPENDING LIMITS

Each designated lead campaign can spend

£1.5 million

in the 16 weeks prior to the poll.

ADDITIONAL CAMPAIGN SPENDING BY PARTY

[determined by share in 2011 Scottish Parliamentary elections]



Cost of the referendum: Expected costs **£8.7 million** for the administration of the poll, regulation and public awareness.

REGISTRATION DEADLINE

MIDNIGHT

SEPTEMBER
3
2014

YOUNG PEOPLE AND THE REFERENDUM

The vote will be extended to voters aged 16 on the day of the referendum.

RESULTS

Results will be tallied and announced by council area.

INTERNATIONAL IMPLICATIONS

Leaders from states with their own independence or autonomist movements and members of the EU will be watching carefully.



IF YES, NEGOTIATIONS WILL TAKE PLACE ON

ECONOMIC LINKS | BORDERS AND SECURITY | CITIZENSHIP AND PASSPORTS
OIL REVENUES AND NATURAL RESOURCE OWNERSHIP | EU MEMBERSHIP

Important dates:

UK Parliamentary Elections:



Proposed independence day in event of a yes vote



ISSUES AT STAKE



CURRENCY



DEFENCE



FOREIGN AFFAIRS



ECONOMY



PUBLIC POLICY



Compiled by
The Future of the UK and Scotland
www.futureukandscotland.ac.uk

The Economy



Question 1: What would the outlook for Scotland's economy be if the vote is Yes/if the vote is No?

David Bell

Trying to predict the economic consequences of constitutional change poses some difficulty, because nothing about Scotland's economic future can be known with certainty. There may be a superficial appeal in predicting that you will be £1,400 better off within the union or £1,000 better off under Independence – as the two sides in the campaign have done – but both forecasts are almost certainly wrong.

Nevertheless, there is a lot of evidence about Scotland's past economic history, much of which is helpful in thinking about the future. This creates an imbalance, because almost all of the evidence relates to Scotland's history within the union. Alternative histories under different constitutional arrangements are not available.

Even where there is evidence, disentangling cause and effect can be difficult particularly where politics is involved. A lot of economic change is driven by forces over which individual governments have little or no control. Governments often try to take credit for events that their policies did not shape, or to blame external factors when their policies are the real cause of adverse outcomes.

The background

What are the main things we know about Scotland's economic performance? First we know that the economies of Scotland and the rest of the UK have moved closely together since 1999, when the Scottish parliament came into existence giving Scots enhanced powers to control their own economy. Between 1999 and 2013, the Scottish economy grew at a rate of 1.6% a year, while the UK economy as a whole grew at 1.7%. This is a relatively small margin compared to the difference in growth rates between the UK as a whole that of other economies over the same period.

The average UK growth rate over this period was close to the average of countries in the Organisation for Economic Co-operation and Development (OECD), lower than some of the small states in Europe, higher than others. Growth went into reverse during the Great Recession, but the UK's performance before then raised its average growth rate above that of most major European economies.

The unemployment rates in Scotland and the UK as a whole from 1992-2014 match each other very closely too. The difference between Scotland and the UK is small compared to the international variation in unemployment rates. By international standards, the UK unemployment rate was relatively low over this period.

The evidence from both the goods market and the labour market suggests that Scotland's economic fortunes over the last two decades have closely followed the UK as a whole. But what does this mean for the outlook for the Scottish economy under independence or as part of the UK?

What do the two sides say?

Recent forecasts by the Institute for Fiscal Studies and HM Treasury *assume* that, under independence, Scottish productivity would grow *at the same rate* as the rest

of the UK. They do not explain their assumption, but might argue, on the basis of the historical evidence, that this would be reasonable.

Nevertheless, if their assumption of equal productivity growth is incorrect, even by a small amount, then the Scottish and rest of the UK economies could diverge quickly. For example, the Scottish Government has recently argued that if Scotland's hourly productivity could be raised by 0.3% per annum above the UK growth rate, tax receipts *could* be £2.4 billion higher by 2029-30.

This sum is roughly equivalent to the current revenue from non-domestic rates. So, if this extra productivity could be found, for example, business rates could be completely removed without damaging public services. Alternatively, capital investment in hospitals, roads etc. by the Scottish Government could be almost doubled without the need to raise tax rates. The key question, however, is how independence will change the economic landscape to cause Scottish productivity to grow significantly faster than that in the rest of the UK. Unfortunately, none of the contributions to the debate thus far have been clear about how Scotland's productivity record might be improved.

Some are convinced that independence will stimulate a renaissance in Scottish business that will increase business activity. What the economist J.M. Keynes called 'animal spirits' will be let loose on the Scottish economy. From this will come increased productivity and enhanced economic growth. This does not really constitute hard evidence, but cannot be entirely ruled out because, as we have argued above, the future is uncertain.

However, there would be limits on Scotland's potential for economic growth. One mechanism that has been a huge part of China's economic success is the ability to create opportunities for individuals to move from non-productive or low productivity work into making a more valuable economic contribution. Many Chinese subsistence farmers have become factory workers during the last two decades. In Scotland, this option is not available: it currently has the highest employment rate of the four UK nations. Currently 73.5% of those aged 16-64 are in employment.

The Scottish Government estimates that Scotland's employment rate is 4.4% below that of Sweden. Pushing Scotland's employment rate up to that of Sweden would almost certainly provide a one-off boost to Scotland's growth rate. But many of the Scots who are not employed now are not in the labour market through choice. They either have other commitments or do not wish to work because the costs of doing so outweigh the benefits. Their average productivity is likely to be well below the average for the Scottish workforce as a whole. It would be unrealistic to expect that this group would boost Scotland's economic growth by 4.4%.

Structural change

Independence would constitute what economists sometime describe as a 'structural change' – a break in established ways of doing things – which could result in radical changes in business relationships and working practices. The greater the extent of the structural change, the more difficult it is to predict its outcomes, positive or negative.

The Baltic States – Latvia, Lithuania and Estonia – have gone through a double transformation since the mid-1990s, from being part of the Soviet Union under communism to being independent capitalist states. In the last decade, these

countries have grown four times faster than the established 15 EU member states. But the transformation that they have undergone has been far more radical than that envisaged for an independent Scotland and they started from much lower levels of per-capita income. Hence it is impossible to argue that they provide good comparisons for an independent Scotland.

One well-evidenced effect that might influence growth in an independent Scotland is the so-called 'border' effect. It predicts that Scotland's trade with the rest of the UK (currently its largest trading partner) would decline after independence. Trade *within* countries tends to be greater than trade *between* countries. This finding holds even when the countries are part of a free-trade zone such as the European Union (EU) or the North American Free Trade Association (NAFTA).

So, although both Spain and Portugal share a land border, trade between the two is much less than trade between Catalonia and other parts of Spain. Similarly, trade between Canadian provinces that adjoin the US border is greater than their trade with the US. Based on information on trade between Scotland and the rest of the UK, and between Ireland and the UK as a whole, it has been estimated that Scottish GDP would fall by 5.5% due to the border effect. Over time, Ireland has reduced its trade dependence on the UK and expanded its trade with other parts of the world, notably Europe. To mitigate the border effect, Scotland would have to engage in similar trade diversification.

One particular issue that a newly independent Scotland would face is debt. In May 2014, UK Public Sector Net Debt stood at £1.284 trillion. The expectation is that on independence Scotland would have to accept roughly its population share of that debt. The need to service and roll over this debt would make it difficult for the Scottish Government to increase public spending until it could demonstrate to the markets that it had the willingness and ability to control its debts. The costs of not doing so would be that the markets force interest rates on Scottish debt above UK levels and potentially to unsustainable levels. This might not affect growth in the very long term, but in the short to medium term would force cuts in public spending and/or increases in taxes that would likely hurt growth.

Thus, the forecasts in the White Paper *Scotland's Future* which show the Scottish economy coming close to budget balance by 2017-18 implicitly assume a continuing decline in the Scotland's annual budget deficit. In turn, this implies a continuation of the reductions in public spending that have already been set in train to overcome the relatively large budget deficits experienced in Scotland and in the UK as a whole in the wake of the 2008 financial crash. In an independent Scotland, just as in the UK as a whole, it is difficult to imagine that following a less-deflationary public spending policy than the rest of the UK to boost growth would be an option in the short to medium term. The reliance will have to be on animal spirits rather than lower taxes.

Tackling inequality

Though economic growth would have an important influence on the Scottish Government's ability to provide high quality public services or to lower taxes, it is not the only economic objective that an independent Scottish Government is likely to pursue. The ability to introduce policies to reduce income inequality also form an important part of the independence prospectus. Reductions in inequality can be supported from a social justice perspective, but increasingly they are also finding

support from those seeking to promote economic growth. The argument is that high income inequality has a negative effect on jobs which in turn holds back growth.

The argument is that independence will provide the policy levers over taxation and benefits to address inequality. It is certainly the case that UK income inequality is relatively high. But this is largely the result of the extremes of income in London. In the UK outside of London, and in Scotland itself, inequality is relatively lower – on a par with other European countries, but higher than the Nordics.

Taxation and benefits policy can help to address inequality. The Nordic countries tend to have slightly higher top rates of taxation starting at a lower threshold, and more generous contributory benefits. Taxes such as inheritance tax can also be used to address intergenerational inequalities. However, taxes and benefits actually effect inequality in a rather superficial way – although they determine people’s disposable (after-tax and benefit incomes), the real reason why the Nordic countries have lower levels of inequality is that the distribution of their *before-tax* incomes is more equal.

The causes of the UK’s higher rates of income inequality stem from the 1980s, when large scale deindustrialisation, combined with labour market deregulation and reductions in trade union power acted to reduce wages for lower paid workers, whilst financial deregulation helped to increase wages at the top. Since then, technological change and globalisation have been major drivers of inequality. The expanding role of computers to perform automated tasks has enabled a large swathe of average-paying jobs to be mechanised and/or offshored. This has increased the supply of labour chasing low-skilled jobs, bidding down their wages. At the same time, the earnings of the highest skilled jobs in management and professional occupations continues to increase.

Addressing these global causes of inequality is challenging. During the early and mid-2000s, inequality in the Nordic countries increased more rapidly than in the UK, as these countries struggled to balance job security and international competitiveness.

How inequality changes in future is likely to be strongly determined by the role that technological change will play in influencing the demand for skills. Education will continue to play a very important role in determining economic fortunes both individually and collectively, and will be a key factor shaping the distribution of pre-tax incomes in future. Tax and benefit policy can help tackle inequality, but it is not in itself a panacea, not least because, in a small open economy such as Scotland’s, the effectiveness of fiscal policy (government control over tax and spending) may be limited by the fact that people, incomes, and firms can move out of the country in response to tax changes.

Conclusion

What can we say about the outlook for the Scottish economy? If there is a No vote the Scottish economy will continue to follow the fortunes of the UK economy. Whether this performance has been good or bad, and whether therefore its continuation is acceptable, is a judgement that people will likely make based on their personal circumstances. Under independence, animal spirits may prevail – or they may not. It is a difficult call. The evidence is much more difficult to gather and to interpret. An independent Scottish economy will inherit a large amount of physical, social, and most importantly human, capital. The key question is whether they can

be brought together in such a way as to significantly improve the prospects for the Scottish economy, given the constraints that it inevitably faces.

Question 2: Which currency arrangement would an independent Scotland use?

Angus Armstrong and Monique Ebell

Why is this important?

The single most important economic question in the Scottish independence referendum is which currency arrangement would an independent Scotland use? By 'currency arrangement' we mean both the currency and the role of the central bank that issues it. The choice of currency arrangement matters far more than just the notes and coins in peoples' pockets. It determines the menu of available economic policy options, the interest rates at which people borrow money and the capacity of the economy to deal with crises.

Both sides of the debate accept that if Scotland becomes independent, then the existing currency arrangement would come to an end. The Scottish Government proposes using sterling in a formal monetary union arrangement, which would involve sharing the Bank of England. As the Bank of England is an institution of the UK, this would require the full support and participation of the rest of the UK. Yet the UK Government has made clear that it considers this to be impractical and not in the interests of citizens in either state. Therefore, the electorate faces an extraordinary impasse on the most important economic question of the referendum.

Before looking at the currency arrangement options, it is important to consider how the economic structure of Scotland would change with independence. First, it is widely assumed that an independent Scotland would be awarded 85% (a 'geographic' share) of the remaining oil and gas fields. Scotland would be a relatively large exporter and the UK would be a small importer of oil and gas. Second, an independent Scotland would be expected to take on a fair share of the UK's existing public debt. Assuming relative population size is a fair measure, an independent Scotland's share of gross debt would be £143 billion or 86% of GDP. Third, the Scottish Government would be responsible for all public spending, taxation and borrowing, and cross border fiscal transfers (tax receipts from Scotland to the UK and the block grant and other payments, such as welfare benefits, from the UK to Scotland) would cease.

What does this imply for the best currency arrangement for an independent Scotland? We consider the economic implications of each of the three widely discussed options below. Note, we do not consider the euro because this requires Scotland to have its own currency (and meet the Maastricht criteria) and so is not an immediate option.

Option 1: Formal Monetary Union

A formal monetary union involves two or more states using the same currency and sharing a central bank. Some monetary unions occur within a single sovereign state, such as between the states in the US or provinces in Canada. Monetary unions also exist between sovereign states. The nearest example is in the euro zone where national central banks delegate monetary policy to the supra-national European Central Bank (ECB). Members of the euro zone are moving towards greater political and fiscal integration to shore-up its monetary union.

The simplest case for using a single currency comes down to a trade-off: using the

same currency reduces the cost of cross border trade, but it also means the same interest rate for all states. If economic cycles are similar, then the same interest rate is likely to be reasonably appropriate. If cycles are dissimilar, but wages and prices are flexible and capital and labour can move freely, fully flexible markets might be able to correct for differences in unemployment between states. Finally, countries which share risks through a common tax system, common fiscal policy or a common welfare state will also find it less costly to keep a common interest rate, even if their economic cycles diverge.

The UK Government argues that the UK is already a fully functioning monetary union, underpinned by a political union between all nations of the UK. Regional economies are deeply integrated, there are common institutions for sharing risks, such as the welfare state, and a political union which allows interests to be expressed while ensuring agreements are enforced. Scottish independence would end political union and risk sharing institutions.

The Scottish Government argues that the rest of the UK and an independent Scotland would still be integrated enough to form a basis for a formal monetary union, even without political union. It proposes sharing the Bank of England according to population size, which would give an independent Scotland possibly one of nine votes when monetary policy is decided. System wide financial policy would also be conducted by the Bank of England with any losses apportioned between states after the event.

We argue that the best choice of currency arrangement for an independent Scotland is very tightly linked to the share of UK public debt it would inherit. Put simply, the amount of public debt determines how stable a currency union would be. When a currency union collapses, the economic and social costs from financial disruption far outweigh the possible costs from exchanging currencies. According to the IMF the average loss in output relative to trend from financial crises in advanced economies is over 20% of GDP. These are losses which can take a generation to regain, and are orders of magnitude greater than the cost of possibly higher exchange costs. Avoiding a financial crisis from a compromised currency system must be the overriding objective.

The level of public debt matters for the stability of a currency union because it can limit the policy options when a large negative shock occurs. Shocks are unpredictable events, such as a sudden drop in tax revenues from North Sea oil or financial market turmoil. With its own currency, Scotland would be able to soften the blow by reducing its own interest rates. In a formal monetary union, however, Scotland would only enjoy lower interest rates or a weaker currency if it suited the rest of the UK. The more the economies grow apart, the less likely these interests will be the same. For oil prices the interests of an independent Scotland and the rest of the UK would be in opposite directions.

The next option is to borrow more. This is where indebtedness matters. As the Scottish Government will inherit a large debt burden, borrowing even more may prove difficult or expensive. The only option left would be to impose austerity to prevent the deficit rising further which, as we know, can be politically unpopular.

Would a formal monetary union be stable? If there were any doubts that Scots, in these circumstances, would accept the austerity, investors would be less likely to lend to the Scottish Government. This is a slow form of capital flight (funds being

withdrawn from the country) which, once it starts, is very difficult to stop without being rescued by another government or even the IMF. In the euro zone the ECB has had to ignore international treaties that were meant to prohibit bailing-out independent countries. The rest of the UK will be weary of entering into a currency arrangement that opens even the possibility of a similar outcome. We can also look back to history, to the Czech and Slovak velvet divorce in 1993. The Czech and Slovak governments agreed to keep using the same currency and to share the central bank. Capital flight forced the governments abandon the monetary union after only 39 days.

Option 2: Dollarization

Although the UK Government and the opposition parties have all ruled out a formal monetary union, an independent Scotland could use sterling on an informal basis, an arrangement popularly known as ‘dollarization’.

The critical difference between a formal monetary union and an informal currency union is that Scotland would have no share of the Bank of England. The Bank of England would choose interest rates and monetary policy to suit the rest of the UK, regardless of whether it is appropriate for Scotland or not. The concerns around financial stability when public debt is high are even greater under dollarization. The arguments laid out above about the instability of having limited policy options when monetary policy and currency policy are unavailable, and borrowing may be difficult or expensive, apply equally to dollarization.

Central banks have a unique ability to create money. They are natural providers of emergency loans to financial institutions (and governments) when citizens and investors lose confidence in them. Dollarization would leave Scotland without any entity under its control that is capable of creating money, and hence without a natural backstop for its banks. The Scottish Government would need to build up enough reserves through years of running balance of payments surpluses, or Scottish banks would need to be much more cautious to make needing assistance very improbable.

The most likely outcome of dollarization is that Scottish banks would move to the rest of the UK where they would have the backstop of the Bank of England. UK banks would then provide banking into an independent Scotland through a branch network. Since the supply of loans into a foreign jurisdiction is generally a riskier proposition than at home, the cost of borrowing by private citizens is likely to be higher in Scotland under dollarization. Financial stability policies in Scotland would be decided by authorities in the rest of the UK and for the benefit of the rest of the UK only.

Option 3: Scotland’s own currency

The currency option that an independent Scotland can unequivocally deliver is issuing its own currency. Having its own currency and controlling its own interest rates would provide the greatest amount of policy flexibility. The more flexibly Scotland can respond to shocks, the greater the stability of its economy. True, trade costs would rise as Scotland and the rest of the UK would no longer use the same currency, but these costs pale in comparison to the costs of financial instability.

Many successful countries in Europe with similar wealth and population sizes (such as in Scandinavia) and dependent on neighbouring markets have their own currency.

The challenge is how to leave a formal monetary union and create a new currency in as orderly way as possible. Usually, breaking up a currency union involves stamping banknotes in the breakaway territory to create a new currency. However, Scotland already has its own distinctive banknotes. It would be far easier to introduce a new currency on the back of years of balance of payments and fiscal surpluses to give citizens and investors confidence that the value of the new currency value would be maintained. This would require a marked, but possible, shift in economic management.

There are other significant challenges. While private debt contracts – mortgages and loans to Scottish firms – could be redenominated into Scots pounds, Scotland's obligations to repay its share of the UK public debt would, at least initially, be denominated in UK pounds. Leaving the debt denominated in UK pounds would imply that any depreciation (loss in value) of the Scots pound would lead to higher interest and capital repayments to the UK. These risks are likely to mean in turn higher credit risk for UK banks. It would therefore be in the interests of the rest of the UK to support the Scottish Government to ensure as smooth a transition as possible.

Conclusion

The moral of the story was best expressed by Professor Michael Dooley: 'Exchange rate regimes are born at conference tables and laid to rest in foreign exchange markets.' Governments can choose whatever currency arrangements they wish, but private citizens and financial companies will decide whether or not they are stable. As we approach the referendum it appears that we are heading towards the option of 'dollarization' almost by default and without the full consequences being considered. Yet 'dollarization' is an option that the Scottish Government's Fiscal Commission Working Group does not consider a 'clear option for Scotland.' While introducing a new Scottish currency has serious transitional challenges, it may be the best option for a prosperous independent Scotland.

Question 3: What would the picture for the Scottish Government's finances be if Scotland votes yes? What if Scotland votes no?

David Phillips

The outlook for the public finances of an independent Scotland is a key battleground in the referendum debate. Why? Because the health of the government's finances determine how much can be spent on public services like schools, the NHS, welfare and pensions. It is also key to understanding whether taxes can be cut or need to be increased to avoid the government borrowing unsustainably. Ultimately it affects how much money individuals and families will have in their pockets, and the quality and quantity of public services they can enjoy in the years ahead.

If Scotland votes No

At the moment most tax paid by people and businesses in Scotland goes into one central pot controlled by the UK Government, which is responsible for defence, foreign affairs and for paying benefits and state pensions to Scottish people. It also gives money as a block grant to the Scottish Government to pay for devolved services – it is then up to the Scottish Government to decide how to allocate this between services such as schools, hospitals, policing, transport etc. The size of this grant does not depend on how much tax revenue is raised in Scotland, but is based on historic spending. In recent years the grant has been large enough to allow total government spending in Scotland to be around 11% higher per person than the UK average.

If Scotland votes No this would continue – for a few years at least. Some small taxes are due to be devolved to Scotland in April 2015, and the Scottish Government will gain more powers over the rate of income tax in Scotland a year later. This will mean some extra risk for the Scottish Government's budget – revenues from these taxes can be volatile – but also bigger incentives to grow the economy. Still, most taxes will go to Westminster and come back to Scotland in the form of a block grant. The Scottish Government's finances will still depend on the size of this grant.

Since 2010, the block grant has been cut by 8.8% after accounting for inflation. This is a result of the UK Government's wider spending cuts designed to reduce the large budget deficit caused by the 'Great Recession'. Under current UK Government plans, these spending cuts will continue until 2018–19 (by when the UK as a whole should be running a small budget surplus). This could mean that for the next five years cuts in the block grant would be even bigger than those made so far. The Labour Party says it would not cut quite so deeply, but would still likely be looking to make further cuts to government spending.

In the longer-term, the pro-union parties have offered further devolution if Scotland votes No – for instance, further control of income tax policy.

If Scotland votes Yes

Independence would mean the Scottish Government would have full control over taxes and spending. This would give additional freedoms, but also new responsibilities. In particular, an independent Scottish Government would bear all the risk of volatile tax revenues as the economy fluctuates. While it could borrow

money in the short-term to make up for any deficit, in the longer-term it would need to ensure tax revenues were high enough to pay for spending to ensure that the budget was sustainable.

The Scottish Government's estimates show that in 2012–13, tax receipts (including oil and gas revenues) were £789 higher per person in Scotland than across the UK as a whole, but government spending was £1,256 higher per person. This means Scotland's notional budget deficit for that year was 8.3% of Scotland's GDP (national income), which was bigger than the deficit of 7.3% of GDP for the UK as a whole.

The past is not necessarily a good guide to the future though, and whether an independent Scotland's government finances would be stronger or weaker than those of the UK will depend on a number of factors:

- How much of the UK's national debt Scotland would inherit,
- How strong oil and gas revenues are in future,
- How well the broader economy of Scotland would perform.

Disagreements about these factors are what underlies the starkly different visions for the public finances of an independent Scotland outlined by the Yes and No campaigners.

What does the No side say?

Better Together and the UK Government argue that the government of an independent Scotland would face a worse financial situation, necessitating spending cuts or tax rises on top of those planned by the UK Government.

Based on the independent Office for Budget Responsibility's (OBR) forecast for further declines in oil revenues and Scotland taking on a population-based share of the UK's public debt, the UK Government says that an independent Scotland would have a budget deficit of 5.5% of GDP in 2016–17. This is substantially higher than the UK's 2.4% deficit forecast for that year and means the Scottish Government's budget deficit would be around £1,000 higher per person. Such a large budget deficit would not be sustainable and would require Scotland to make spending cuts or tax rises that were bigger than those planned by the UK.

The UK Government then looks 20 years to the future and argues that voting No and staying with the UK would mean a £1,400 per person per year 'union dividend' – or, put another way, a Yes vote would mean a £1,400 'independence penalty'. It argues that most of this penalty would arise from the fact that, under independence, Scotland's onshore revenues – from income tax, VAT, National Insurance etc – and declining oil revenues would not be enough to pay for the relatively high government spending that Scotland enjoys as part of the UK. They also say there would be set-up costs of independence, costs associated with Scotland's more rapidly ageing population and the Scottish Government's proposals for a more generous welfare system. As a new country with no record of repaying creditors, the Scottish Government would need to pay a higher interest rate on its borrowing.

Some people have argued that the UK Government's estimates of the set-up costs of independence are too high and that it has included the cost of more generous policies, but not the benefits. But it is worth noting that, even if these costs were ignored entirely, the extra costs the UK Government says would be incurred amount to an 'independence penalty' of more than £1,100 per person per year.

What does the Yes side say?

Yes Scotland and the Scottish Government have said oil and gas revenues will increase in future and an independent Scotland's public finances will be 'similar to, or stronger than' the UK's by 2016–17. The Scottish Government's central projection is for Scotland's oil revenues to be about £7 billion in 2016–17, up from £5.6 billion in 2012–13 and about £4.1 billion last year. This is a lot more optimistic than the OBR's forecasts, which imply revenues of about £3 billion in 2016–17.

On this basis the Scottish Government forecasts a budget deficit of 2.8% of GDP in 2016–17, if Scotland took on a population-based share of the UK's national debt. This compares to a deficit of about 2.1% of GDP for the UK as a whole under such a scenario. If Scotland took on a lower share of the UK debt – which increasingly looks like something the Scottish Government wants to negotiate – Scotland could have less debt interest to pay, so its deficit would be lower.

Looking further ahead, the Scottish Government says that because of higher oil revenues it would aim to *increase* public spending a little in the first three years rather than cut it and reduce the budget deficit to 2.2% of GDP in 2018–19, which it says would be 'sustainable' and would allow it to start building up an oil fund for the future. But because it would still have a deficit – unlike the UK, which plans to have a small budget surplus by 2018–19 – it would have to borrow the money it was putting in to that fund.

In the longer term, the Scottish Government claims that independence would give it tools to boost the economy. It suggests that *if* an additional 115,000 jobs were created, annual growth in labour productivity were boosted from 2.2% to 2.5%, and net immigration into Scotland were boosted from 16,000 to 24,000 per year, onshore tax receipts would be £5 billion a year higher after 15 years than would be the case without these improvements. This would be a £1,000 per person per year 'independence bonus'.

But would it? If an independent Scotland's government finances would otherwise be similar to the UK's, an additional £1,000 in revenues clearly would be a bonus. But, unless oil and gas revenues were to rebound and stay high, Scotland's public finances would be weaker than the UK. Although the Scottish Government has published forecasts for oil revenues up to 2018–19 it has not said explicitly what it thinks will happen after that. If oil revenues declined over the longer term, as the OBR forecasts much, or all, of the additional £1,000 might be needed to compensate and to maintain Scotland's existing relatively higher levels of government spending.

What do other experts say?

Experts at the IFS, Stirling and Glasgow universities agree that both the Scottish and UK Government's analyses of the starting position in 2016–17 could be correct depending on whose oil revenue forecasts you believe. But, they also suggest that the predictions of the Yes side are based on optimistic assumptions that independence will lead to economic improvement – which might not happen.

Oil revenues may be higher than forecast but they could also be lower.

Researchers at the IFS say: 'whilst it may turn out that the Scottish economy does a great deal better after independence than it would as part of the UK, planning on this as a central assumption seems less than cautious.'

So, what is the bottom line?

It looks likely that the Scottish Government's finances will be squeezed in the years after 2016 whether the public vote Yes or No. If Scotland remains part of the UK, cuts to grants from Westminster are set to continue until 2018–19. If the vote is to leave the UK, an independent Scottish Government would likely have to make spending cuts or tax rises of its own just to balance the books. Delivering the promises in the White Paper would need further tax rises, spending cuts in lower-priority areas or higher borrowing.

Even if oil revenues do rebound, Scotland were able to negotiate a favourable deal on the national debt and net immigration were to increase, fixing an independent Scotland's government finances for the long term would probably require bigger tax rises or spending cuts than the UK would need. This is because if oil revenues eventually decline that will knock a much bigger hole in an independent Scotland's budget (oil contributes around 10% of Scotland's total revenues, compared to less than 1% for the UK as a whole).

An independent Scotland could increase some taxes and there would be options for cutting spending. Independence would give more freedom to pursue a different, and perhaps better, economic policy, to undertake the radical, politically challenging reforms that could generate additional growth. But it is much easier to say things would be better *if* the economy grows quicker than it is to develop and implement policies that would actually deliver that extra growth. The Scottish Government has suggested a few policies – such as cuts to corporation tax and expanded childcare – but the immediate effect would be to cost the government money (and hence weaken its finances) and the effects on growth look unlikely to be enough to offset this.

Whether you believe Scotland's government finances would be in a better state if Scotland votes for independence, should depend on two things.

- First, do you think the Scottish Government could find new policies to deliver a sustained increase in economic growth; and
- second would that additional growth mean higher tax receipts that will more than outweigh the long run decline in oil revenues.

If so then an independent Scotland might be able to continue with its relatively high public spending without much in the way of additional tax increases. If not the Scottish Government's finances would likely be weaker if the result is Yes.

If the vote is Yes...



Question 4: If the vote is Yes, how long will the independence negotiations take and what will the main challenges be?

Nicola McEwen

Independence is a process not an event. That process would be kick-started by a Yes vote in the referendum. The dynamics that these negotiations take, as well as their outcome, could determine the kind of country an independent Scotland would be. The transitional period between a Yes vote and an independence settlement would be a period of anxiety for some and of opportunity for others. This chapter examines how the two sides see the process of becoming independent and looks at the key challenges.

The negotiation process

When the Scottish and UK Governments signed the historic ‘Edinburgh Agreement,’ which paved the way for the referendum, they each committed to work together in light of the outcome, whatever the result. A recent joint statement of the two governments confirms that ‘If more people vote ‘Yes’ than vote ‘No’ in the referendum, Scotland would become an independent country’. It seems a Yes majority, even if won by the narrowest of margins, would trigger independence negotiations. These negotiations would confront a number of challenges.

The first would be to determine who makes up the negotiating teams. We can expect that negotiations would be led by the two governments, but it would be for the governments to determine how inclusive or exclusive their team should be. The Scottish Government has indicated that its team would be led by the First Minister and would include ‘figures from across Scottish public life and Scotland’s other political parties.’ Given that if a Yes vote was secured, it would likely be with a slender majority, it would be important to try to ensure that the negotiating team was regarded as genuinely representative of Scottish interests. That means involving, or at least engaging with, those who found themselves on the losing side, including political parties and representatives of regions who voted against independence. The challenge would be to ensure that the team could include those who genuinely represented other parties and interests while being able to maintain unity of purpose and decision-making capabilities focused on securing the best deal for Scotland.

The UK Government has said little about how it would approach independence negotiations; defeat in the referendum is not a prospect either side could comfortably contemplate at this stage. But it would face similar, if not greater, challenges in composing a negotiating team. Some of those giving evidence to the House of Lords Select Committee on the Constitution leaned towards a team of only UK ministers, as was the case when negotiating Irish secession nearly a century ago. The committee itself favoured this option to ensure the team remained ‘small and able to act quickly and with authority.’ However, this raises three further complications. First, the UK Government includes ministers representing Scottish constituencies; indeed those who are most familiar with the issues being debated in the referendum are Scottish MPs. The Lords constitutional committee recommended that they be excluded from being part of the rest of the UK’s negotiating team, a

position which the Secretary of State for Scotland appeared to endorse. Second, the imminence of the UK General election in May 2015 makes the exclusion of other political parties very risky politically. It could see the negotiation process becoming a politically contentious issue within the UK election campaign. The election itself might produce a new government which wants to reopen agreements reached at an earlier stage of negotiations. Third, there would be strong pressure from the devolved assemblies in Wales and Northern Ireland to ensure their interests were represented in the negotiation process – the UK Government would surely be keen to avoid encouraging nationalist sentiment in other parts of the UK.

A second challenge would be to ensure that the negotiations were as transparent as possible, with both negotiating teams accountable to their respective parliaments. Both the Scottish and Westminster parliaments may have a role to play in giving a legislative footing to the negotiations and both would have a key role in scrutinising the process. This creates an ambiguous position for those MPs representing Scottish constituencies who would still be sitting in Westminster until the point of independence. There would be strong pressure to curtail their rights to participate in any part of the scrutiny process – and to curtail their right to participate in and vote on other matters not directly affecting Scotland. The parliaments would also have to ratify the outcome of negotiations, including passing legislation to give effect to independence, as well as any legislation required to put in place agreements related to shared institutions between an independent Scotland and the rest of the UK.

The third challenge is the timetable. The Scottish Government envisaged a timetable for negotiations which would enable it to declare independence on 24 March 2016. This would mean Scotland could assume its status as an independent country in advance of the Scottish elections scheduled for May 2016. There are differing views among academic experts over how realistic this is. In his evidence to the House of Lords Committee on the Constitution, Professor Alan Boyle noted that the Irish negotiations and the negotiations leading to the break-up of Czechoslovakia lasted just six months. Since many of the issues are similar with respect to the division of assets and liabilities and future relations between the two states ‘the 18 months envisaged by the Scottish Government may appear generous.’ On the other hand, Professor Iain McLean argued that the timetable was unrealistic because the timing of the UK General Election would make it difficult to agree anything during the first eight months following a Yes vote, while Professor Adam Tompkins suggested that the Scottish Government’s 18 month timetable was ‘preposterous’ both because of the timing of the UK election and the complexities of the ‘mighty, difficult task’ of unpicking a 307 year old union.

The Scottish Government’s timetable for negotiations is aspirational. It is not set in stone and cannot be imposed upon the team negotiating for the rest of the UK. Indeed, one of the first decisions for the teams may be to agree a set of principles to guide the process of negotiation, including a proposed timetable or key milestones. The significance of the UK General Election to the timetable for negotiating independence may depend on the extent to which the current UK Government reaches out to the main opposition party in composing its own negotiating team and conducting negotiations. The outcome of the election obviously matters too – a

change of government could produce a change of priorities; the re-election of a Conservative-led government is more likely to maintain continuity of approach.

Negotiation dynamics and the key issues at stake

Both governments will have an obligation to negotiate in good faith, but each will also be keen to get the best outcome for their respective constituents – and be seen striving to do so.

Before deciding how institutions, assets and liabilities will be disentangled the two parties might determine what would be shared. There are around 300 public bodies which currently operate at the UK level and act for Scotland. The Scottish Government envisages that around 180 of these would transfer their functions to new or existing bodies in Scotland upon, or following, independence while around 90 could continue to be shared, including the National Lottery, the Green Investment Bank, the university research councils, the Civil Aviation Authority, and NHS Blood and Transplant.

It may be possible to reach agreement quickly on sharing some functional institutions, provided there was agreement on how to fund their operations. Other proposals for sharing arrangements post-independence may be more problematic, and sharing key institutions may require the equivalent of an international treaty. A currency and central bank may fall into this category. The Scottish Government seems intent on pushing for a formal currency union in spite of an apparent consensus among the UK parties rejecting this proposition. While this may lead one to conclude that such a united opposition could mean this issue is dealt with quickly (by taking currency union off the table), it would be inextricably linked with other contentious issues. In his evidence to the Scottish Affairs Committee, Professor Iain McLean suggested that a scenario in which the UK Government says ‘on day one, hour one, minute one, ‘You cannae have the pound; that’s the end of the issue’ ’ is implausible because it would then be easy to envisage that on day one, minute two, the Scottish Government would respond with a hardline insistence on the speedy removal of nuclear weapons from the Clyde. Such a scenario would be difficult for the UK since there is currently no obvious base to which the missiles could relocate.

The division of assets and liabilities is discussed in detail in another chapter, but in principle, both governments would be under an obligation to try to agree an equitable apportionment. But determining what is ‘equitable’ is a political matter. Different principles may apply to different assets. For example, in some cases, it may be appropriate to apportion a geographic share to Scotland for land or sea-based assets, such as oil and gas, or buildings owned by the Crown Estate or the defence estate. It may be more complicated when it comes to UK buildings which are also part of the machinery of UK Government. The Scottish Government assumes that many of the 30,000 UK civil servants currently working in Scotland will transfer to the Scottish Government upon independence. In some cases, it suggests agreement could be reached to deliver some services jointly, for example, to cover pensions and benefits. The future of UK Government offices and their personnel would clearly be a matter for negotiation. Sharing bureaucracies, while feasible, would come at a price which is not just financial – it would entail a degree of intergovernmental policy co-ordination that could limit the options for either government to implement different policies.

Population rather than geography will be a more appropriate guide to the division of some assets. This may, in effect, be a population-based share of the *value* of assets rather than the assets themselves, for example, in the case of embassies or consulates overseas or defence equipment. With respect to the division of debts, the expectation would be that each party take an agreed share of the national public debt, but the Scottish Government may argue that rather than simply using population share as the guide, the historic contribution made to the UK's public finances (presumably including North Sea oil wealth already spent) should also be taken into account. It has also suggested that it may choose to offset part of the share of UK assets against inherited debt. The rights of, and obligations to, third party creditors would also have to be considered.

Conclusion

As with many issues discussed in this book, it is impossible to give definitive answers to the questions concerning the process and timing of negotiation. In any negotiation, there is give and take on both sides. Not everything need be agreed before Scottish independence can be formally recognised by the UK Government and the international community. Becoming independent, and renegotiating the relationships between the nations and regions of these isles, would be an evolving process, not a one-off event. But given the inevitable uncertainty that would follow a Yes vote, the attendant risks of such uncertainty on the behaviour of citizens, businesses and investors, and the nervousness which is likely to be felt among other states at the potential repercussions of an independence vote beyond these shores, there would be enormous pressure on both governments to negotiate an agreement on the key issues as quickly and as cleanly as possible.

Question 5: If Scotland votes Yes, how will assets and liabilities be divided?

Angus Armstrong and Monique Ebell

In the event of a vote in favour of Scottish independence, England, Wales and Northern Ireland would become the continuing UK state and Scotland would become a new, separate sovereign country. The institutions of the current UK, such as the Bank of England, would continue to be institutions of the UK but no longer responsible to Scotland, unless both sovereign states agree otherwise. All liabilities – promises to pay – incurred by these institutions after independence would belong to the continuing UK only and would not be the responsibility of an independent Scotland.

There is, however, the issue of dividing up the assets and liabilities of the current UK state at the time Scotland might become an independent country. This division is crucial for the viability of alternative economic frameworks (see in particular Question 2, on the currency arrangement) and capacity for an independent government to manage the economy. Despite the fluidity of international borders over the past sixty years, which has seen dozens of new sovereign countries created, history offers surprisingly few precedents on how to divide state assets and liabilities. Some claim that the UN Vienna Convention of 1983 (Article 40) provides a legal basis. Yet the convention only requires an 'equitable' division of assets and debt, leaving 'equitable' undefined. Moreover, the Convention was not ratified by any OECD country and so hardly constitutes a legal guide.

Public sector assets and liabilities

The best register of UK public sector assets and liabilities is the Whole of Government Accounts (WGA) published by the UK Treasury. These give a total asset figure of £1,268 billion (the sum of physical assets, plus other assets and equity investments) which is quoted in the Scottish Government's White Paper as the 'net' assets to be shared if Scotland becomes independent. This includes £745 billion of physical assets including property in the UK and overseas and the infrastructure, such as the road network. Most of the physical assets are specific to their location and it is not obvious that a market value would be as high.

The WGA exclude natural resources, such as the countryside and environment, and, in particular, the remaining North Sea oil and gas fields, which would be keenly contested in negotiations. Maritime experts expect that the oil and gas fields will be allocated by location, with the median line between Scotland and other parts of the UK the most likely boundary. On this basis, an independent Scotland could receive up to 84% of tax revenues from the remaining reserves. The amounts involved are uncertain and disputed. According to the Office of Budget Responsibility's (OBR) central forecast, the total undiscounted tax yield between 2019-20 and 2040-41 is estimated at £39 billion. If an independent Scotland is awarded a geographic share of the oil and gas fields, the tax yield would be £33 billion in cash terms. This benefit to Scotland is mirrored by a tax loss to the continuing UK.

Public sector debt

Since the union was created, all citizens of the UK have also benefited to a greater or lesser extent from the services and investments provided by the state. If Scotland becomes independent, the new Scottish state will be expected to compensate the

continuing UK state for being relieved of (i.e. no longer obliged to pay) its share of outstanding UK public debt at the date of independence. This compensation is complex and raises three important issues.

- Which measure of existing UK public debt is appropriate?
- How would the public sector debt be divided?
- How would an independent Scotland assume its share?

Which measure of debt?

The amount of debt to be shared depends on the definition of debt. The WGA net liabilities of £1,347 billion already take into account the assets and include known future obligations. It is therefore the most complete measure of the UK's obligations and can be thought of as a counterpart to the Public Sector Net Debt (PSND) used by both the UK Treasury and the Scottish Government in their projections of fiscal sustainability. The OBR forecasts that PSND will reach £1,439 billion at the end of the fiscal year 2015/16, the date at which independence would occur. A broader measure of Gross Debt is more often used internationally and does not allow for netting-off liquid assets or the exclusion of debts issued by other public bodies. We prefer this measure as a more accurate indication of funding pressure because, in practice, all governments require a stock of liquid assets and therefore deducting them provides a low estimate of the amount of debt which has to be incurred. Gross debt is also less vulnerable to changes in statistical classifications than the PSND (expected later this year) which do not change the actual debt outstanding. The UK gross debt is projected by the OBR to be £1,701 billion at the end of 2015/16.

How to divide the debt?

Once the measure of debt has been agreed, the next issue is the basis on which it is to be divided. There have been two cases of 'friendly' campaigns for independence that provide some guidance: first, the separation of Czechoslovakia in 1993; and second, the vote against Quebec's independence from Canada in 1995. So far as general principles can be drawn, fixed assets are generally divided on the basis of physical location. This makes sense as most of the fixed assets are specific to their location, such as roads or the National Galleries in Edinburgh, or in London in Trafalgar Square. Non-physical assets and liabilities are divided on some basis of 'fairness' or equity, of which two main measures are a population and ability to pay.

The division of UK debts would be an important negotiation and we can illustrate how positions of the two sides might differ by looking at the different definitions of debt. On a population basis, an independent Scotland would be responsible for 8.4% of the outstanding debt. Scotland's initial Gross Debt (on the widely used international measure) would be £143 billion, or 86% of Scottish Gross Domestic Product (GDP). On the narrower PSND measure an independent Scotland's debt would be would fall to £121 billion, or 73% of GDP. The latter ratio is included in the UK Treasury and Scottish Government reports.

The Scottish Government has suggested a third approach based on what they call a 'historic' share since 1980, which would leave an independent Scotland with debt of £109 billion or 64% of GDP. The key issues are whether starting in 1980 is reasonable (rather than some other date) and whether a retrospective calculation is justified. For example, had Scotland kept the oil tax revenues since 1980, is it reasonable to assume everything else would have been unchanged (e.g. would there have been a monetary union)? Yet another option is 'ability to pay'. On this basis an

independent Scotland would have a higher per-capita GDP including North Sea oil output and so would take on a greater share of public debt than all of the amounts quoted above.

The Scottish Government has also raised the idea that the £375 billion of UK Government bonds bought for Quantitative Easing (QE) and held by the Bank of England, could be deducted from the PSND. The apparent reasoning is that as these are assets held by one arm of the state, so they can be 'cancelled out' against government debt. However, there are at least two serious problems with this argument. First, the assets have been bought by issuing another offsetting liability (namely newly created money) of the same value so the government bonds held for QE are already balanced by an equivalent liability, so there is no net asset holding for the government. Second, when the assets mature new debt (in the form of government bonds) will need to be issued by the UK Government to repay the Bank of England. For these reasons we are very doubtful that the QE assets can somehow be 'cancelled out' and deducted from the PSND measure of government debt.

How would Scotland assume its share of debt?

The precise means of transferring the debt is also of great importance. The UK Treasury has already assumed full responsibility for all UK Government debt. This ruled-out somehow sharing out the outstanding debt, which would have probably constituted a technical default. This leaves two broad options for the Scottish Government to compensate the UK. The first option is where Scotland pays the full amount of its share at independence, which we call a 'clean break' option. A simple back of the envelope calculation (taking the duration of UK public debt at 8.5 years and discounting at 4.1% the average yield on 10 year UK gilts since 2000) reduces the present value of a population share of Gross Debt to £102 billion. 'Clean break' implies the Scottish Government pays the UK Government £102 billion in cash in 2016/17. This might be partially accomplished by a 'debt for oil' swap, or by the independent Scottish Government issuing new bonds to raise this amount of money. Raising £102 billion in capital markets might be quite challenging for a newly established country, however.

The second option, noted in the Scottish Government's White Paper, is that an independent Scottish Government would commit to paying its share of interest and principal payments as and when they fall due. We call this the 'IOU' option. We take this to mean that if the UK's debt stock included, say, £1 billion of five year 'gilts' (government bonds due for repayment in five years) and Scotland were responsible for 8.4% of the debt, then Scotland would pay the interest on £84 million, when it fell due every six months, and repay £84 million of the principal at the end of the five years. The same pattern would occur across the 'overall maturity profile of UK debt'.

The important issue is what this implies for the debt repayment schedule of an independent Scotland. The amount of debt an independent Scotland would need to issue in its first year has three parts: the amount of debt to be re-financed as it matures (described above), plus interest on the remainder of the IOU, plus enough to cover any new budget deficit (revenues minus spending) which might be incurred. We have argued elsewhere that an independent Scottish Government would have to borrow £23 billion in its first year. However, the UK Treasury takes a far more lenient approach than we do. It assumes a population share of PSND rather than Gross Debt and that only 5% of the debt matures in the first year. Based on these assumptions, the total amount of debt to be raised in the first year of independence

would be only £16 billion. A critical question is the cost at which an independent Scotland could borrow this amount.

Borrowing costs

Even if an independent Scotland uses sterling, there is no reason to assume that it would have the same borrowing costs as the rest of the UK. For example, eurozone countries have very different borrowing costs despite using the same currency. We have estimated that an independent Scottish Government would be likely to pay between 0.72% and 1.65% higher interest rates than would be the case for the UK for borrowing over ten years. Our analysis shows that the most important factor for this higher rate is the size of the country. Large countries have much bigger markets for government debt than small ones, meaning that investors can buy and sell their holdings more easily. They compensate for this by charging small countries higher rates of interest.

The higher borrowing costs would be another factor adding to the higher debt requirement in the first year of independence. Higher government borrowing costs would also be likely to lead to higher borrowing costs for households and businesses in an independent Scotland compared to the UK. However, the increase might not be as much. Private citizens generally borrow for shorter periods than governments (e.g. mortgages are tied to short term interest rates). Therefore, private borrowing costs are likely to reflect differences in short term interest rates, which are likely to be much smaller than the ten year interest rates we estimated.

The extent to which an independent Scotland using sterling would have higher borrowing costs than the rest of the UK depends on the nature of the currency arrangement. With all of these debt figures fresh in the mind, we recommend readers turn to Question 2 on the currency arrangement. We cannot stress enough the importance of considering the currency question in conjunction with the debt issues discussed above.

Question 6: If there is a Yes vote, how long would it take to set up a new Scottish state and how much would it cost?

Patrick Dunleavy

How the UK state operates is well known to Scotland's voters. But how would a Scottish state work? How costly would it be to establish new institutions in the short term? How feasible is the transition process proposed? And how long would it take, and at what cost, to achieve the separation of Scottish governance completely from the UK?

These issues have only so far been addressed in a rather fragmented way in the Scottish Government's White Paper *Scotland's Future* and in a series of UK civil service briefings discussing various detailed problems that an independent Scotland might face. The public debate has not really addressed these issues in a clear way. A UK Treasury briefing in late May 2014 did not help, containing as it did some spectacularly wrong information, which greatly muddied the waters. What we try to do here instead is to show what definite costs we can estimate will be incurred in the short term – these are genuine 'set-up costs'. We also look at the longer term costs of achieving a transition to Scottish independence – using the timetables and commitments included in the Scottish Government's White Paper (which are the only ones available).

The key tasks in achieving a smooth transition

The Scottish Government have pledged that their top priority will be to achieve a smooth transition to independence by March 2016. What that means in concrete terms is summed up by the really big things Scotland must do for itself.

A new **Scottish Defence Force** (incorporating army, navy and air force units) would need to be established. This will probably include around 10,000 personnel, plus a new Defence Directorate inside the Scottish Government, perhaps involving around 3,000 staff (current Ministry of Defence staff in Scotland is somewhat more than this).

A new, integrated **Scottish Security and Intelligence Agency** would need to be set up also, covering internal security, overseas intelligence gathering and electronic and cyber security. Following the Scandinavian pattern, it would work closely the national police force for Scotland, already established by the SNP government.

Scotland would also need to create a **foreign ministry** and a core group of overseas embassies covering major countries, probably building out from existing overseas Scottish Government offices. A full embassy network covering about 50 countries would come later. Initially many Scottish embassies might sit in UK or other EU countries' embassies.

These are the only brand new agencies that Scotland will need. But in addition a large number of staff would transfer from the UK to the Scottish Government. Just under 8,000 people work for the UK's tax agency HMRC in Scotland (not all on Scottish taxes) – they would need to be incorporated into a greatly expanded **Scottish Finance and Economy directorate**.

Some 9,500 staff work for the UK's Department of Work and Pensions in Scotland, again not all on Scottish benefits alone. They would come under a greatly expanded

Scottish Government directorate covering **social welfare alongside wellbeing** and NHS in Scotland (already devolved).

And finally the currently beleaguered UK **Passport Office** would need to transfer its Glasgow staff over to Scottish Government control.

Of course, modern government is not just about central government departments directly controlled by ministers. A lot of routine or technical work also goes on in agencies, separated from main departments, or in arms-length public bodies handling professional issues that we don't want ministers to interfere in directly. So the big changes above are only part of the picture. There are 206 departments, agencies and bodies that the UK Government says currently handle Scotland matters. Medium scale bodies spend some significant amount of money or implement services, but small or tiny bodies make up a third of the total – they do specialist tasks, or are just advisory committees. Many bodies are already operating on a shared basis with Scotland's devolved government and so do not need major reorganisation, as with most UK-level NHS bodies.

Much of UK Government is highly elaborate and long-lived, however – so it is not at all clear that a Scottish Government would need all these bodies. In fact, we have carefully considered the full list and concluded that 43 of them would not need Scottish Government equivalents. We are also clear in some cases that issues handled by multiple bodies at UK level would require only one Scottish body. Our judgements are not in any way the official choices of the Scottish Government – but they do at least suggest that there is a considerable scope for 'streamlining' what gets done north of the border, compared to UK practice. In fact, we think that rather than 206 bodies Scotland would need no more than 136 bodies, of which less than 60 would be new and of any significant size at all.

What will all this mean for central government within Scotland? We believe there would have to be a big change in the scale of civil service, but not that much change in how it operates.

Currently the policy-making Scottish Government operates with just 5,000 civil servants, using a modern and effective way of organising called 'directorates.' In contrast to the deeply embedded 'silos' of Whitehall departments, Scottish Government is currently run as a single organisation using the same human resources and IT systems, but with six directorates. Beyond this core, there are other major agencies doing discrete tasks (like the Scottish prisons) that are separately managed. Each of the Scottish directorates usually works for several ministers with different policy briefs. The most senior ministers are called Cabinet Secretaries and always attend cabinet, while other ministers go as needed based on the day's business. Most current Scottish cabinet meetings have around ten ministers present, and there are only a couple of sub-committees. This has proved a very effective pattern of government, with staff numbers held down, spending controls well managed and policy development generally at least as good as that in the UK.

After independence the Scottish Government plan to maintain their directorates, but to enlarge the number from five to nine, with the First Minister running a small policy directorate handling transition negotiations, and eight others. One of these will be wholly new (covering defence and foreign affairs). Three others are greatly expanded but drawing on some existing experience (foreign affairs, finance and tax, and social security). On the face of it, these plans are clear and modest, drawing on

existing strengths and developing them. The Scottish cabinet would also be bigger, with probably around 15 people sitting around the table from 2016 instead of ten, and more sub-committees. But compared with all other OECD governments, which generally have around 15 separate ministries, Scotland's nine directorates answering to around nine top rank Cabinet Secretaries (and more ministers) still looks lean.

The transition timetable

The single best attested lesson of all public management is that the costs (and other risks) of a speedy or forced transition are always greater than those changes that are properly planned, trialled and phased, so that effective implementation can take place at each stage. In the Scottish case the government has actually set out in its White Paper a reasonable timetable for implementing changes. The key decision that Salmond and colleagues have made is to move rather briskly from a Yes vote to independence, but to focus on just the key tasks. By 2016 Scotland will have policy control of some of the biggest issues, but even in defence its capability will only just be beginning, and no complete separation from UK systems is envisaged.

Even in important areas like defence planning, back office and procurement, and some taxes, it will take a considerable time for Scotland to build up its own systems. And in some technical areas, that matter a lot less for Scottish policymaking, the transition will take more than seven years. For instance the registering of vehicles and licensing of drivers carried out by DVLA and three other UK agencies will continue to be based in Swansea until at least 2021.

So what would happen with things that have not been moved over to full Scottish control? The Scottish Government will obviously want to brand and manage all its communications with citizens – so websites and forms would carry the Saltire and contact details for staff based in Scotland. But for some years the 'back office' systems for both tax systems and benefits would need to run through the existing, very complicated computer and IT set-ups in the HMRC and DWP. And only when these systems were fully replaced with new Scottish ones would ministers in Edinburgh gain the full freedom to vary benefits for Scottish citizens (planned for 2018) and personal taxes in Scotland (planned for 2020).

Throughout these longer transition periods then, how would Scotland continue to get the continuing services it needs from Whitehall? The details would need to be negotiated with the rest of the UK, but in every case Scotland would have to pay the existing costs for these services, plus a small addition.

The costs of transition (and possible offsetting savings)

There are five main types of costs (and also potential savings) involved for Scotland here.

Set-up costs are those incurred by Scotland only, in the early transition period (especially from a Yes vote to March 2016) in duplicating a capacity that already exists in the UK. These costs are unavoidable, one-off costs of transition that create no additional or offsetting welfare gain for Scotland's citizens. We have estimated the set-up costs for Scottish Government as being in the range from £150 million to £200 million – that is £30 to £40 per person. If Scotland can do the job the UK

apparatus does with fewer or smaller bodies, then it can generate streamlining savings to offset the set-up costs.

Disentangling costs arise because current UK-run processes treat Scotland and rest of the UK citizens in a merged way. Following a Yes vote, governments on both sides of the border will need to de-merge data about citizens, taxpayers, benefits claimants, business taxpayers and so on, and perhaps change some back-office operational processes so as to re-allocate them. The rational thing for both Scotland and London governments is do each of these tasks only once, so that the costs involved would be shared between them.

Transition costs occur when Scotland negotiates or contracts with the rest of the UK to keep doing part of processes that would cost too much to change during the transition period. Notice here though that only the *extra* cost of the contract negotiation and monitoring are new burdens borne by Scottish taxpayers – with unchanged systems the main bulk of services costs will be the same after independence as they were before.

Investment costs have to be borne by Scotland in order for its policy makers to gain full control over the tax, benefits and defence areas, running all the back-office systems in a self-sufficient way. When the new Scottish Government and parliament have designed their tax and welfare policies for the long term Scotland can invest in modernised, purpose-built computer systems and administration to permanently replace UK provision. And as the Scottish Defence Force builds up, they too can take over their own command and control, procurement and other complex back office functions. The UK Treasury has not given any specific numbers for defence, but they have put forward some large numbers about two other areas. They say:

- the Scottish Government would need to pay £400 million to create new IT systems and processes to handle all welfare benefits itself – which is targeted to happen by 2018; and
- they would need to pay £500 million to create IT systems capable of handling all their tax administration – the main bulk of which is due to happen by 2020.

These estimates are not based on any careful analysis, but given prevailing IT and change costs they do not seem implausible. However, these are not just ‘set-up costs,’ because Scotland would be replacing older and complex legacy IT systems in each case, with newer, modern IT systems that would last for a long time (at least ten years), and could well be cheaper and far more flexible to operate. Hence these are investments (not just set-up expenses).

Policy cost savings would accrue to Scotland if it no longer needed to cover costs, such as the costs of running nuclear weapons systems. In 2013-14 the UK Ministry of Defence had costs of £47 billion, a sixth on which was capital spending, and the vast bulk on gross operating costs. The Scottish Government anticipates spending only £2.5 billion a year on defence and intelligence combined. This is a lot less than Scotland’s population-proportional share of around £4 billion a year for MoD costs. Cumulated over a decade, such policy savings might quickly dwarf set-up costs. On

the other hand, the Treasury argues that a leaked paper from Scotland's finance minister, John Swinney, included a passage estimated that the annual costs of running the Scottish tax systems would be around £600 million a year. This is actually far higher than Scotland's population-proportional share of HMRC costs, which would be around £300 million. The evidence basis for the Swinney estimate seems to have been slender, derived from looking at the proportion of GDP spent on tax collection in Ireland and New Zealand. It seems highly unlikely that Scotland would need to double HMRC's costs.

Conclusions

The two absolutely critical influences on Scotland's likely overall transition costs are:

- the realism of Scottish Government planning for independence, which generally seems high. However, it does assume that a moderate and rationalist approach will be taken by the government in Westminster; and
- the stance that London ministers would actually take in negotiations over the transition, which remains largely undefined.

This analysis does not offer any positive reasons for voters to choose Yes or No, for that was not our purpose. Just because a step might be feasible, and not too costly, is not in itself a reason to take it. Scotland's voters will make up their own minds what to do, and for their own reasons. But they can be broadly confident that, whatever the majority decides, future Scottish Government will be generally effective and well organised.

If the vote is No...



Question 7: If the vote is No, would we get more powers? What difference would they make?

Charlie Jeffery

The Question

At first sight the referendum offers a simple choice: a Yes vote for independence or a No vote for the status quo. The reality is less straightforward. Other contributions in this book look closely at what independence means for the Yes side. They show that what is on offer in many respects involves a lot more continuity in Scotland's relationship with the rest of the UK than the word 'independence' might usually suggest.

Likewise what the No side is offering is not simply about an unchanging status quo. Change is going to happen anyway – in 2012 a new Scotland Act was passed which boosted the powers of the Scottish parliament by giving it a new ability to tax and borrow along with a small number of new policy powers. Much of this is already in place, but the most important new measure – giving the parliament partial control over setting income tax rates in Scotland – is still to come into force in 2015.

Since the 2012 Act the pro-union parties have been in a debate about whether to go further still. Each set up their own commissions to come up with proposals for more devolution. The Liberal Democrats reported first in late 2012. Labour followed in March 2014 and the Conservatives in June.

The various proposals differ in detail and emphasis but have plenty of common ground, especially around more devolution of tax and some welfare policies. The three parties came together around this common ground in June 2014 with a joint pledge to 'strengthen further' the Scottish parliament and to put their proposals in their respective manifestos for the May 2015 UK General Election.

Why all this is important

The pro-union parties are signalling that No doesn't mean the status quo, or even the status quo plus the new powers of the 2012 Scotland Act, but a Scottish parliament with significant extra powers beyond that.

The Liberal Democrats have long argued for more devolution, but Labour and the Conservatives are more recent converts. While some in each party genuinely support a stronger parliament, there is also a strong whiff of tactics here. Opinion among Scottish voters doesn't correspond neatly with the Yes/No choice we have in September. It is split three ways: one third support independence, one third the status quo, and one third a middle ground in between (sometimes known in shorthand as 'devo-plus' or 'devo-max').

The middle ground voter prefers a stronger Scottish parliament than now, but not independence. Here is a key battleground for the two sides in the referendum. The Yes side's offer of independence with all sorts of continuities with the rest of the UK (currency, broadcasting and all the rest) is aimed at that middle ground. So too is the No side's offer of more devolution.

What the No side says

Tax

Tax devolution has been the most high profile issue in the debate about more devolution. The Scottish parliament currently has little say about raising the money it spends beyond setting council tax and business rates. Instead the great bulk of the parliament's funding comes from a block grant from the UK Government. The size of the block grant is set by the so-called Barnett formula and enables the parliament to spend more per head of population in Scotland than is the case in England (which at times provokes controversy in England).

Many argue that that this situation of very limited tax powers and block grant funding encourages irresponsibility in spending decisions. Others think the parliament doesn't have the right incentives to look to grow the Scottish economy if it has no stake in the tax receipts from economic growth. The tax proposals of the pro-union parties are attempts to tackle these arguments. If the parliament had to make more tax decisions itself to fund its spending, and justify those decisions directly to Scottish taxpayers, it might think more carefully about what it spends. And it might look more to do things which boosted the economy and with that its own tax receipts.

The tax proposals fall into two categories. One is simply to give the parliament some or all of the power to set the bands and rates of particular taxes. Air passenger duty – a surcharge on every air ticket – is one which the Conservatives and Liberal Democrats, but not Labour, would want to see devolved. The effect (at least if the duty were cut) might be to boost tourism or open up new business opportunities by encouraging airlines to introduce new routes.

The most important differences are about income tax. The Liberal Democrat and Conservative proposals would give the Scottish parliament full control over tax bands (currently basic, higher and additional) and the rates at each band (currently 20%, 40% and 45% depending on income level). With these powers the Scottish parliament could create different bands compared with the rest of the UK and set rates higher or lower than in the rest of the UK. Labour's proposals do not offer flexibility on bands, which would still be set UK-wide. But they would allow variation in tax rates, including a new 'Scottish Progressive Rate' which could increase (though not reduce) the higher and additional rates in Scotland relative to the standard rate.

The effects of decision-making powers on income tax, whether the more limited Labour version or the fuller Liberal Democrat/Conservative version, would be very visible in people's pay packets and tax returns. Any changes would certainly prompt public debate and require the Scottish parliament to justify more fully the spending proposals that would be funded in this very direct way by the Scottish taxpayer (and rewarded or punished by the Scottish taxpayers' votes at the next election).

The other category of tax proposal is to leave decisions on the rates of particular taxes to be set UK-wide by the UK Government, but to work out the proportion of UK tax receipts generated in Scotland and to allocate those receipts to the Scottish parliament's budget. The Liberal Democrats would allocate a Scottish share of UK corporation tax receipts to the Scottish parliament in this way, and the Conservatives have said they would explore whether to do the same with Scottish VAT receipts. In

each case there would be an incentive for the Scottish parliament to take measures which would increase Scottish receipts from corporation tax or VAT.

Labour does not propose similar measures for corporation tax or VAT. Together with the more limited proposals on income tax, Labour's tax proposals are by some way the most modest of the three pro-union parties. This appears to reflect divisions within the party about the desirability of more devolution, with the parliamentary party at Westminster less open to further devolution than the party in the Scottish parliament and the Westminster party winning out.

Though none of the parties' reports say this explicitly, it is likely that the amount of block grant received from the UK Government would be reduced in proportion to the amount any new Scottish tax-setting powers or any shares of receipts from UK-wide taxes would bring in. This approach was established in the 2012 Scotland Act. One effect would be to remove some of the controversy around the Barnett formula (which has been used to calculate the Scottish block grant until now), because the amount of funding it would allocate would be much less.

Welfare

Each of the pro-union parties also proposes welfare devolution, though none of them would want to devolve higher cost benefits like pensions. The emphasis instead is on benefits that connect closely with existing devolved responsibilities. The Liberal Democrats have least to say here except for a greater Scottish Government role in implementing the UK Work Programme so as to connect it better to Scottish training and skills policies.

Both Labour and the Conservatives would devolve Housing Benefit to connect to existing Scottish parliament responsibilities in housing policy, and Attendance Allowance for pensioners needing care in their homes, which connects with existing responsibilities in health and social care. Labour would also devolve the Work Programme, but give responsibility for it to local authorities rather than the Scottish Government. The Conservatives would enable the Scottish parliament to supplement benefits still run on a UK-wide basis.

At their fullest extent these proposals on tax and welfare devolution are clearly significant and would have direct impact on Scotland's citizens, whether through benefits received, taxes increased (or reduced) and – if all the incentive effects worked in practice as well as in theory – higher economic growth. In addition all three parties would take steps to strengthen the powers of local government and introduce modest new policy-making powers for the Scottish parliament along with new institutional arrangements either to strengthen the legal status of the parliament and/or to build improved links between Scottish and UK political institutions.

What the Yes side says

The Yes side's response to the pro-union parties' proposals on more devolution has been very simple: the pro-union parties cannot be trusted to deliver. This is often accompanied by recollection of the commitments given by senior Conservatives in the late 1970s that if the Scots rejected the proposals in the 1979 devolution referendum, the Conservatives would deliver a better alternative after the next UK

election. They did not. The Yes side message is in effect 'don't get fooled again' and that the best way to guarantee a stronger Scottish parliament is to vote Yes.

Would the No side deliver?

So would the No side deliver? There are no guarantees that they would. The closest to a guarantee was given in June 2014 when the three pro-union parties made a joint pledge on more devolution. This focused on the common ground around tax and welfare devolution and foresaw that each would write a commitment to pursue this common ground in their 2015 UK election manifestos.

The common ground may be substantial, but there are still significant differences. Labour lags behind the other two and appears to have more internal party divisions to contend with. There is a suspicion too that the Conservative Party may also have divisions that have not yet surfaced. Given such actual and potential *internal* party differences it may be difficult to maintain *cross-party* consensus.

And much may depend on the outcome of the 2015 UK General Election. Many commentators envisage another hung parliament which could make the parliamentary arithmetic for a further Scotland Act challenging – especially if the new UK Government rested disproportionately on support from MPs in England. There is also a question mark around the sense of priority that Scotland would have either if the No vote had been a clear one, or if other matters pressed higher onto the agenda at Westminster – not least that parliament's enduring concerns about European integration.

There are though two counterbalances that could help ensure delivery of a new Scotland Act with significant additional powers for the Scottish parliament following a No vote this September.

The first lies in the pledge made by the pro-union parties in June 2014. Although it was painfully thin on detail, it exists. We can be sure those parties will be reminded of this and will be aware that the middle ground voter wanting more devolution but not independence will have alternatives to the pro-union parties both in the 2015 UK election and the 2016 Scottish parliament election. If those parties are felt to have gone back on their pledge there is likely to be only one beneficiary, the SNP.

The second lies in the process of legislating on more devolution. Assuming a Bill is brought in at Westminster it would also – as the 2012 Scotland Act did – need the consent of the Scottish parliament, which has an SNP majority until 2016. So more devolution is not just a matter for the pro-union parties, but one on which the SNP has a say. That would certainly keep the pressure on the pro-union parties to deliver.

So, would they? They would certainly be foolish not to.

International



Question 8: What kind of international role and influence would an independent Scotland have?

Juliet Kaarbo and Daniel Kenealy

If the referendum results in a Yes vote, Scotland will emerge, after a transition period, as the world's newest state. Whilst many policy areas (such as health, education, and criminal justice) are already under Scottish authority, independence would bring new responsibilities and opportunities. The leaders of an independent Scotland, and Scottish citizens, would have to design and support a foreign policy for their country, and decide how best to gain influence, secure their interests, and promote Scottish values in the international system. An independent Scotland would quickly find itself in a world that puts many constraints on states' international aspirations. But as a sovereign state, Scotland would have the opportunity to shape the role it would play on the world's stage. What kind of foreign policy would Scotland have and how much influence could it exert in the international system?

Important, but often overlooked

Although voters may be more immediately concerned with the effects independence might have on the economy, their pensions, and their personal prospects for employment, the issue of Scotland's international role and influence remains important. Indeed, given Scotland's current control over many of its internal policies, its foreign policy as a sovereign state is, with defence, one of the most distinctive differences that would materialise after independence. The significance of this question has been recognised by both the Yes and No camps and by parliamentary enquiries in London and Edinburgh. Its importance has also been recognised by other countries, international organisations and foreign observers who have voiced opinions about an independent Scotland's international role.

For citizens of Scotland, an independent foreign policy is important because it would impact on the other issues voters say they care most about. The economy for instance: whether an independent Scotland secures a quick and seamless transition to EU membership could have significant economic implications. Similarly, in negotiations with the UK Government following a Yes vote, issues such as whether the Trident nuclear submarines would stay in Scotland and the division of defence and diplomatic assets will represent key bargaining chips in a broader negotiation that will have considerable economic consequences.

In our highly connected and interdependent world, no state can isolate itself from developments outwith its borders. Sovereignty does not mean autonomy. What is happening with climate change, in Asian financial markets, and in terrorist training camps affects the health, wealth and security of residents of Scotland. All modern states recognise the importance of having influence in international politics and the connections between the external world and internal conditions.

Those interdependencies make an independent Scotland's international role significant to the world. A wealthy Scotland fully integrated in regional or global agreements for economic co-operation means a good trading partner for others. An independent Scotland, no matter which path it chooses for its foreign policy, disrupts existing relations that others have with the UK. President Obama, for

example, has stated an interest in seeing that the UK remains 'strong, robust and united' given its position as a key US ally and a key contributor to NATO's nuclear capabilities. Others have voiced concerns about Scottish independence as a precedent for other independence movements. The issue is therefore an important one, both within Scotland and beyond.

The Yes vision of an independent Scotland in the world

The White Paper *Scotland's Future* sets out the Yes campaign's vision of an independent Scotland's international role and influence. That vision combines continuity with change. Continuity would be provided by on-going membership in a variety of international organisations, perhaps most prominent amongst them NATO and the EU. But there would also be the possibility of change as an independent Scotland would be free to pursue a set of values and interests somewhat distinct from those of the UK.

States' visions of their international role can be portrayed in terms of four foreign policy pillars: protection, profits, principles, and pride. The Yes campaign proposes Scottish membership of NATO and a Scottish defence force as cornerstones of 'protection.' (See Question 10 on defence for more detail). Scotland will earn, 'profit' and thrive, according to the Yes campaign, in the global political economy by adopting liberal, pro-trade foreign economic policies. Central to the 'profit' pillar is continued membership of the EU. The message across these pillars – 'protection' and 'profit' – is, to a large extent, one of continuity. An independent Scotland would continue to be embedded in a range of alliances and institutions geared to provide security and prosperity.

Independence, however, would also bring forth prospects of change. In the area of 'principles,' ethics, and values, the Yes camp proposes a highly aspirational policy, contrasting it with its characterisation of past and present UK foreign policy. The White Paper emphasises the 'different international priorities' that an independent Scotland would pursue, seen 'most clearly in matters of war and peace and in our relationship with the EU'. The pledge to rid an independent Scotland of nuclear weapons is also grounded in principle.

The Yes campaign describes an independent Scotland as a 'champion for international justice and peace,' committed to the values of 'international development, human rights, climate change, and climate justice.' And Scottish defence forces would be used, in addition to national defence, to support international peacekeeping and humanitarian missions undertaken under the auspices of the UN and in support of international law. Scotland would also contribute in a targeted way to NATO and EU missions.

The vision is thus one of Scotland as a good global citizen with a 'do no harm' principle, especially to developing countries, firmly embedded in its international role. Finally, 'pride' has a place in most states' foreign policies. Pride involves the projection of self-image by a country and the White Paper paints a picture of Scotland as 'an outward facing nation, exporting goods, people, and ideas around the world ... [with a] proud military tradition'.

The No vision of a strong Scotland within a strong UK

The No side sees Scotland stronger as a part of the UK than it would be on its own. The argument is captured in the phrase 'A strong voice in the world'. Given that the UK is a permanent member of the UN Security Council, one of the largest members of the EU, and already an experienced participant in other influential international organisations, Scotland's interests, according to the No campaign, are better advanced through these existing channels and institutions and as part of a larger state. Their messages stress, in terms of sheer numbers and expenditure, how much larger the UK diplomatic service, the UK economy, the UK armed forces, and the UK intelligence services, are in comparison to hypothetical independent Scottish counterparts.

Such arguments touch directly on the issue of influence and how it is best attained. For the No campaign influence is best achieved as part of a larger state. The 'Yes' campaign makes the case that an independent Scotland can build on existing goodwill, a trusted and respected 'brand,' and pre-existing international connections.

There has been a tendency by the No campaign to point out the difficulties that Scotland might face in an uncertain world. It is, they argue, important to consider the obstacles that could thwart the Yes campaign's foreign policy aspirations. They argue that the EU will not grant the same opt-outs and special terms (for example on the euro, the Schengen area, and the budget rebate) to an independent Scotland as are currently possessed by the UK. They stress that the NATO alliance may not accept Scotland as a member if Scotland refuses to house the UK nuclear deterrent on its soil. The No side also questions SNP assertions about its rights to UK diplomatic assets, such as embassies and consulates. In short, according to the No side, uncertainty is pervasive and risks abound.

In some respects, therefore, the two sides of the debate are talking past each other with No speaking the language of big states and power politics, and Yes speaking the language of small states punching above their weight.

What do the experts say?

There is little consensus on many of the specific points of contention. Most experts agree with the No campaign that Scotland would be considered a new state in international law, with the rest of the UK as a continuing state. Others interpret the situation differently, seeing both Scotland and the rest of the UK as equal successor states, and others would stress that the legal standing is not as important as the political negotiations that would occur in the transition period. Similarly, while most agree that Scotland would have to apply for membership to international organisations, such as the EU and NATO, most experts see membership to be a very likely outcome, but stress that Scotland will not be able secure everything it wants in negotiations.

The more general debate between the Yes and No campaigns on the influence a small state can have in the world is familiar to scholars of International Relations. Many experts view the international system as dominated by great powers. Weak states are Lilliputians in Gulliver's world and suffer what they must. An independent Scotland would find itself in many situations where it would be dependent on others both in terms of economics and security. Smaller economies can be more vulnerable

in the face of instability in global financial markets. They can also be more dependent on military alliances in the face of security threats and may need to compromise their goals or values in return for protection. The bottom line, for those viewing international politics through the lens of big states making big decisions, is this: small states are rule-takers, not rule-makers.

The opposing view, supported by a growing body of research, argues that small states often have influence disproportional to their size. Small states can play an active role in international organisations, often hosting headquarters and offices and placing their nationals into key leadership positions. Such organisations provide diplomatic space, information networks, and a place to co-ordinate collective action; leadership allows small states to shape the agenda of regional and global organisations.

By prioritising their goals and concentrating their more limited diplomatic resources, small states can carve out niche roles, champion specific issues, and broker agreements, as they often enjoy more credibility and neutrality than larger states, *because* of their small size. The history of international relations reveals many examples of small states playing important roles (consider Norway's influence in the Arab-Israeli conflict during the 1990s or Costa Rica's influence in the Central American conflicts of the 1980s). Small states can use their power, and particularly their 'soft' power of persuasion and example-setting, in smart ways to advance their interests and exert influence. In economics too, small states can find and then exploit highly profitable niches and smaller economies may be able to adapt more easily to changing economic conditions.

Conclusion

There is certainly reason to think that an independent Scotland would be able to play an influential role on the world stage. Academic research has highlighted the different ways that small states can secure their interests and advance their ideals. But it is not automatic; not all small states are effective in overcoming their disadvantages. And an independent Scotland would be giving up any effectiveness it already enjoys as part of the UK.

The credibility that is key to small states' influence takes time to develop and is dependent on how others see them. It takes planning, the selection of appropriate policies, the commitment of necessary resources and the exercise of dynamic leadership for any state – small or large – to deliver a successful foreign policy. Whilst we have a sense, from the Yes side, of what an independent Scotland's aspirations are, the concrete policies that may take us from 'here' to 'there' remain unclear and the conditions that would facilitate an influential independent Scotland cannot be controlled or easily predicted.

The right policies also need the right resources to support them, not only financial resources (a diplomatic network is not cheap) but also human capital. Diplomatic services require the appropriate experience and knowledge and that will require significant and strategic investment. And while the foreign policy of democratic states is certainly affected by the public, it is leaders who steer sovereign ships. Leaders who are interested in foreign affairs and skilled at playing a two-level game of domestic and international politics can significantly enhance any state's potential to successfully translate pillars into policy.

Question 9: Would an independent Scotland be in the European Union?

Michael Keating

Background

When the UK joined the then European Communities in the early 1970s, the SNP was opposed. It campaigned for a No in the 1975 membership referendum, although a Europhile wing was always present within it. Matters changed in the late 1980s, when the SNP embraced the idea of 'independence in Europe.' Since then, membership of the European club has been an essential external support for the independence project.

What does Yes say?

At the start of the current independence debate, positions were polarised. Independence supporters argued that Scotland would remain in the European Union (EU) more or less automatically, while their opponents suggested that it would be out. Those positions have been modified as the campaign has gone on. The Scottish Government now accepts that the UK would be the 'successor state,' so that Scotland would have to apply for membership. They indicate two routes to membership, under articles 48 and 49 of the current European Treaty. Under article 49 they would apply in the normal way, but could be assured rapid progress since Scotland already meets the entry criteria. Under article 48, there would be a treaty change to add Scotland as a 29th member state, allowing for a rapid transition.

The Scottish Government proposes to keep the present UK terms of membership, including opt-outs on the Euro, the Schengen border-free travel area, and Justice and Home Affairs. They envisage the negotiations on the details of membership being concluded in the eighteen-month transition period for independence, so that Scotland would not remain outside the EU for any time.

What does No say?

The position of the No side is less clear, as is that of various people from the European institutions. Commission president José Manuel Barroso has declared that any territory leaving a member state would automatically be outside the EU. Later, he declared in a British television interview that it would be 'difficult if not impossible' for Scotland to join the EU. The House of Commons Scottish Affairs Committee takes an only slightly less intransigent line, accepting that Scotland could join, but insisting on the Article 49 accession process, that the conditions would be extremely onerous and that there was a high probability of being left out while these are negotiated. These hard arguments seem to revisit the whole principle of the right to independence conceded under the Edinburgh Agreement, since the proposal was, from the start, independence-in-Europe and not secession from both the UK and the EU. Less intransigent people on the No side accept that Scotland could join the EU but that it would have to adopt the euro and enter Schengen and would lose the current UK opt-outs.

What do experts think?

There have been contributions from lawyers arguing that the treaties do not provide for membership of a seceding territory. This is true but neither do they deny it; they are silent. Jean Claude Piris, from the Commission, has claimed that the use of article 48 (treaty change) would not be 'legally correct,' but it is not clear what this expression actually means. Member states can amend the treaties in any way they like, as long as it is consistent with procedure.

Many observers have argued that European leaders do not normally look to law to tell them what to do. They decide what they want to do politically and then find a legal means. On this view, we should look to what is in the interest of the existing member states. Many people have argued that no member state, and certainly not the remaining UK, would have an interest in excluding Scotland and disrupting the internal market. Sir David Edward, former judge in the European Court of Justice and Graham Avery, a former director general in the European Commission who has handled previous enlargements, argue that Scotland would be allowed in and that treaty change would be the best way. Neither Edward nor Avery has endorsed Scottish independence as such; they have only explored its consequences, should there be a Yes vote. Other lawyers have argued that the relevant law to apply in this case is not international law but European law. This brings in the matter of European citizenship, which Scots currently enjoy and which gives rights to other EU citizens within Scotland. It might be argued that citizens could not be deprived of their rights because of Scottish independence, especially if they have taken no decision to this effect themselves. There is also the question of the broader democratic principles upon which the EU is based. Many thought it wrong for a Commission president to threaten to exclude from the union five million EU citizens who want to remain in and who meet the membership criteria.

Would Scotland Be Allowed In?

Either route to membership would require unanimity among the existing 28 member states and there have been suggestions that states with their own restive internal nations, notably Spain, might veto Scotland. Yet, invited to state that they would veto Scottish accession, Spanish ministers have declined to do so. Instead, they have taken the line that Scottish independence would not provide a precedent for Catalonia or the Basque Country, since in the UK there is a constitutional provision for Scotland to secede and an agreed process, which is not the case in Spain. This is consistent with stubborn refusal to consider Catalan demands other than through a narrow reading of the Spanish constitution.

Barroso, who continues to view the Scottish question through the Catalan lens, does not seem to recognize this difference probably because of his greater familiarity with Spain and his networks in the European People's Party. He even made an extremely provocative comparison of Scotland with Kosovo. The key difference is that Kosovo is not recognised by Serbia and because of this is not recognised by Spain and some other EU states. If, in the spirit of the Edinburgh Agreement, an independent Scotland were recognised by the UK, there is no reason for any of the remaining 27 states to withhold recognition. Scottish independence would certainly have political repercussions in Spain but the Spanish Government's

position is to avoid it setting a new legal norm; otherwise they really would be in trouble were Scotland to vote Yes.

Europe is currently engulfed by the economic crisis, the problems of the eurozone and the turbulence in Ukraine. It is difficult to see why either the European institutions or the member states would want to add to their troubles by seeking to exclude Scotland, disrupting the internal market and discrediting an eminently democratic means of resolving a self-determination dispute. Keeping Scotland in the EU, under either Article 48 or 49, might be complicated but pales beside the challenges of disentangling Scotland to get it out. Forcing it out of the single market, only to allow it back in again, is the sort of challenge member states can really do without. So it is likely that Europe and the member states will seek continuity in the internal market as well as in citizenship rights. This could be done through declaratory legislation while detailed negotiations on the terms of membership were taking place.

Terms of membership

The argument here is whether Scotland could keep the existing UK opt-outs or not. The legal issue is moot, as Scotland could be defined either as a new state or an existing part of the EU for these purposes. Again, the outcome would likely be determined by pragmatic considerations. No country has ever been forced into the euro against its will. Sweden has no opt-out but shows no sign of joining and would require another referendum to do so. Hungary and the Czech Republic have no intention of joining any time soon. If Scotland were to retain a currency union with the rest of the UK, it might not even be eligible to apply. Nor is it likely that Scotland would be forced into Schengen, especially as the UK Government would have a strong interest in keeping an open border. This makes threats by UK ministers that there could be border posts between England and Scotland questionable; the only authority that might plausibly impose such posts is the UK Government itself.

The costs of Scottish EU membership, like other costs in the independence debate, are difficult to calculate. Figures about payments and receipts under the Common Agricultural Policy are disputed. Future payments under the Structural Funds are subject to negotiation in the next spending round to start in 2020. Scotland's present allocation of Structural Funds is purely notional, since the Treasury's rule is that 'additionality' applies only to the UK as a whole, while distribution within the UK is part of the Barnett Formula. Since the other member states are unlikely to want to reopen negotiations within the current 2014-20 spending round, the easiest solution would be a per capita share within the current UK total. The same might be true of the UK budget rebate, by applying the same formula to Scotland as the UK, subject to not increasing overall payments. For the next spending round, the UK will have great difficulty in keeping its rebate, especially if it has been annoying other member states with demands for renegotiation. Its best, and possibly only, friend, would be an independent Scotland making the same case; this would also allow it to present the matter as one of general principle rather than special pleading.

What would Scotland do in the EU?

With the debate on how Scotland might get into, or stay in, the EU, less attention has been given to what role it might play there. The Scottish Government proposes to keep the same terms as the UK presently has as well as retaining the Pound and various common institutions. At the same time, the UK Conservative Party, and now the Labour Party, are proposing a loosening of the relationship with Europe. The question then arises as to whether Scotland should cling to the UK line and risk being dragged away from Europe, or strike out on its own, with a consequent weakening of links with the UK. So independence in Europe could leave Scotland still in the shadow of the United Kingdom.

We know that small states in the EU have less influence than larger ones, but they can be effective if they are well organised and know their way around the European institutions, and if they have a reputation as constructive players and good Europeans. Scotland would need to learn these skills and position itself as a contributor to the European project, rather than just arguing its own case. As a small state it could not hope to behave like the UK does if it wanted to retain influence.

UK out, Scotland in?

The matter is further complicated by the Conservative promise of an in-out referendum on the EU in 2017. Surveys have shown public opinion in Scotland to be only slightly less Eurosceptic than in England, but the issue is much less politically prominent north of the border. Euroscepticism has little electoral appeal so that the old 'permissive consensus' on Europe still holds across Labour, Liberal Democrat and SNP voters; despite the link between independence and Europe the last group are not particularly Europhile.

There is a broad pro-European consensus in civil society, in business and in the trades unions. Opinion polls have suggested that there is a real possibility that, in an EU referendum, Scotland would vote to stay in and England to come out. Such an outcome following a No vote in the Scottish independence referendum would certainly put the issue back on the agenda. Another possibility is a narrow vote for the UK to stay in the EU, attributable to Scottish votes. It does appear that the present Conservative Party leadership would like to be able to propose a Yes to Europe in a 2017 referendum, but their hold on the issue is precarious and it is by no means clear that they could negotiate a new deal, sell it to their own party, or carry it at a referendum. The issues of Europe and of Scottish independence are likely to remain intimately linked.

Question 10: How would an independent Scotland defend itself?

Colin Fleming

As defence is currently a reserved policy area it has not previously experienced a high level of attention in Scotland. This is no longer the case and there have been a range of House of Commons parliamentary committee enquiries examining defence and security issues relating to possible Scottish Independence. These were followed in November 2013 with the publication of the Scottish Government's White Paper *Scotland's Future* which sets out its vision for an Independent Scottish defence model.

What does Yes say?

The Scottish Government's defence and security blueprint offers a very different model to that currently pursued by the UK. Despite significant cuts to the defence budget following the Coalition government's Strategic Defence and Security Review in 2010 the UK continues to provide a full-spectrum of military capabilities – land, air and sea – with the capacity to be involved in military interventions in situations like Iraq and Afghanistan.

At the core of its defence case, the Scottish Government has provided a commitment that Scottish forces would not be allowed to become involved in a foreign war unless it was sanctioned by the United Nations, supported by the Scottish Government and had the backing of the majority of the Scottish parliament (the so-called Triple Lock). While the UK's strategic effort remains global in scope, Scotland's focus would be on the defence of its territorial integrity as well as taking on a regional defence role in northern Europe. In contrast to the current strategic posture of the UK, with its history as a major international power, the Scottish Government's defence proposals reflect those of a small state.

What would be Scottish defence capabilities and purpose?

The Scottish Government has placed a particular emphasis on cooperating with allies, including the rest of the UK and NATO. Its main strategic interests would lie in maintaining security in the North Sea, Eastern Atlantic and across the Nordic region. This is a natural strategic area for Scotland to engage, but it has been heightened by UK wide defence cuts which have left significant capability gaps in maritime air surveillance and naval surface vessel capabilities in this region – gaps which the Scottish Government has committed to filling.

Scotland's defence forces would reflect the change in emphasis from being part of a large state to that of a small state with a more limited defence budget. Nevertheless, the Scottish Government's proposed defence budget of £2.5 billion is in line with other small European states, such as Denmark, and would enable Scotland to build modern, flexible defence forces capable of responding to regional (and global) challenges in cooperation with allies. It is important to note that Scotland's defence capabilities would not be fully operational by 2016, when Scotland would officially become an Independent state.

The White Paper identifies five 'defence priorities' for an Independent Scotland:

- commitment to a budget of £2.5 billion;

- ensuring the speediest safe withdrawal of nuclear weapons from Scotland;
- a focus on maritime capabilities, such as air and sea-based patrol, and specialist forces;
- progressively building a total of 15,000 regular and 5,000 reserve personnel over the ten years following independence;
- reconfiguring the defence estate inherited at the point of independence to meet Scotland's needs. This would include the transition of Faslane to become a conventional naval base and the joint headquarters of Scottish defence forces.

There is a further commitment to undertake a feasibility assessment of whether Rosyth could be brought back into use as a naval base on the east coast, giving the Scottish Defence Force (SDF) the flexibility to deal with potential incidents in the North Sea.

The SDF would be comprised of 15,000 regular and 5,000 reserve personnel and the Scottish Government would prioritise defence spending to provide naval and air forces able to protect Scotland's long coastline, as well as a mobile army brigade to deploy as part of larger operations if required. The White Paper proposes a 'phased transition' of forces from those currently part of the British armed forces to an all-Scottish force. As a consequence, only certain elements of the SDF would be operational on Independence, with the full transition expected to take around a decade. During this period the Scottish Government would continue to pay a financial contribution to cover UK wide defence. Although there have been suggestions that more than ten years may be necessary, the transition plan appears to provide defence and security continuity while allowing Scotland and the rest of the UK time to undertake detailed planning on future defence arrangements – including potential defence cooperation between the two countries.

This is a pragmatic approach. The UK Ministry of Defence is in the midst of significant downsizing as a result of its own Strategic Defence and Security Review (2010) and is struggling to meet its targets to realign its regular and reserve forces in line with its future defence requirements. A phased transition would be of benefit to both states. At the point of independence the proposal is for an SDF estimated total of 7,500 regular and 2,000 reserve personnel. This would be increased to approximately 10,000 regulars and 3,500 reserves by the end of the initial five year phase of transition. Maximum strength of 15,000 regulars and 5,000 reserves would be reached within ten years.

What the No side say

In its *Scotland analysis: Defence* paper the UK Government argues that Scotland enjoys the protection provided by a larger state with an integrated defence structure which ensures the security of the British Isles – and which is underpinned by its nuclear deterrent. Although the UK Ministry of Defence has had to make significant cuts to its defence budget, the UK military remains a full-spectrum force and the UK Government argues that dividing responsibility for defence would lead to a diminution in security, leaving Scotland open to security threats such as terrorism and cyber-attacks which a UK-wide defence is better able to manage.

In addition, the UK Government makes the case that as part of the UK Scotland has an international presence that an independent Scotland would be unable to

match. The UK Government provides several examples where UK forces have made important contributions to international security including the recent and ongoing military operations in Iraq, Afghanistan, the Balkans, as well as anti-piracy and anti-drug smuggling operations.

The UK Government also highlights its long held status as a permanent member of the United Nations Security Council, NATO, and the EU. It argues that Scotland could not join NATO while simultaneously banning nuclear weapons (a central commitment of the Scottish Government's White Paper). The No side also make the claim that Scottish membership of NATO would be vetoed if it forced the rest of the UK into an early removal of its Trident nuclear fleet from Scotland.

In its *Scotland Analysis: Security* paper the UK Government points to risks and uncertainties of Scotland setting up its own intelligence and security network. It argues that the UK could not guarantee sharing intelligence with Scotland. Moreover, Scotland would not receive the privileged intelligence that the UK does as part of the 'five eyes' intelligence network which also includes the USA, Australia, New Zealand and Canada. It also argues that a Scottish intelligence agency would not be able to replicate the functions of Mi5, Mi6 or GCHQ.

Key debates: NATO and Trident?

At its 2012 annual party conference, the Scottish National Party overturned its long-term opposition to joining the North Atlantic Treaty Organisation (NATO). This position was reaffirmed in the White Paper, which explicitly states that following a Yes vote Scotland would formally declare its intention to join NATO. This issue is complicated by the Scottish Government's commitment to put a ban on nuclear weapons from being based on Scottish territory in a written constitution. As the UK's Trident nuclear missiles are based in Scotland this has become one of the central battlegrounds in the defence debate. Because NATO is a nuclear alliance it has been argued that Scotland's membership would be denied on the grounds of its anti-nuclear stance.

Would Scotland's proposed membership be vetoed? This is an important point of debate, but being anti-nuclear is not in itself a barrier to Scottish membership. The Scottish Government has signalled that it will sign up to NATO's Strategic Concept which rests on it being a nuclear alliance. Refusing to sign would almost certainly prevent Scotland's membership. However, by accepting NATO is a nuclear club the main barrier to membership is removed.

This does not mean that Scotland would gain entry immediately. The stance on the removal of Trident is crucial and NATO will be wary of permitting Scottish membership if the timetable for the removal of Trident forced the rest of the UK into nuclear disarmament against its wishes. Indeed, NATO policy is that candidate members would be refused full membership if there is any ongoing dispute with other existing alliance members. Consequently, if the Trident question were not resolved satisfactorily Scotland could expect to be refused membership initially (though it would be permitted to become an associate member as part of its Partnership for Peace programme).

This being said, it is important to note that the Scottish Government has not provided a set timeline for removal of Trident. Rather, the White Paper notes that it will seek as quick and safe removal of the deterrent as is possible and will enter into

negotiation with the UK Government on the issue. It is significant that the White Paper underlines that a decision on the UK's future nuclear posture (should Scotland become independent) is not a matter for the Scottish Government. Thus, although the Scottish Government has indicated its preferred timetable for removal is at the end of the first parliament of an independent Scotland, removal of the deterrent may take longer. While the exact time it will take to remove the deterrent is hotly debated, the UK Secretary for Defence, Phillip Hammond has suggested around a decade. This seems appropriate and would allow London time to find suitable alternative facilities for Trident if it wished to maintain its current nuclear capability.

Resolving this issue is crucial to membership, as it is to the wider relationship between Edinburgh and London in the event of a Yes vote. If it is resolved, this would pave the way for Scottish membership of NATO. It is clear that there would be wrangling during negotiations, however, it is in no one's interest, not least the rest of the UK, to have Scotland sitting outside the alliance and it is probable that a solution would be found. Given its geopolitical location and existing military infrastructure Scotland is strategically important and membership is in NATO's interests. Although membership is decided by consensus of all 28 alliance members, with the backing of the rest of the UK, it is very unlikely that Scotland's membership would be problematic given its desire and commitment to add to the alliance.

Conclusion

Although there was initial scepticism regarding Scottish defence plans, the plans set out in the White Paper appear credible and affordable. However, like every other European state an independent Scotland would have to make hard choices about its strategic priorities. If Scotland becomes independent it would do so in a relatively benign security environment and would have the benefit of a phased transition. However, given that it would take up to ten years or longer to meet its full operating criteria an SDF would take time to bed down and would need to work closely with the rest of the UK and other allies.

This would require trust on both sides and, alongside Scotland's potential membership of NATO, the Trident question looms large. Dealing with this issue constructively and sensibly would therefore not simply be a discussion about the merits of NATO membership, but also about the long-term relationship between Scotland and the rest of the UK. The onus would rest on negotiators to reach some level of compromise that worked in the interests of both states. Following the full establishment of an SDF there would be no reason why Scotland would not have a flexible, modern defence organisation which would be able to work with partners and bring benefits to the wider security of the British Isles as well as its regional focus in the Nordic region.

What sort of Scotland?



**Question 11: The constitution of an independent Scotland: What will it contain?
How will it be made?**

Stephen Tierney

This chapter analyses the Scottish Government's proposal of a written constitution for an independent Scotland. Providing overarching authority for the parliament and government of the country, as well as a detailed list of citizens' rights, has been a long-standing commitment of the SNP. The detail of this proposal has gradually been elaborated in the course of the referendum campaign, culminating in a draft Scottish Independence Bill, unveiled on 16 June in an address by Nicola Sturgeon, Deputy First Minister to the Edinburgh Centre for Constitutional Law.

Background

In November 2013 the Scottish Government published its White Paper *Scotland's Future*, which declared that an independent Scotland would have a new written constitution. The intention is to replace Westminster parliamentary supremacy with the 'sovereignty of the people of Scotland' since, the Scottish Government claims, popular sovereignty has historically been 'the central principle in the Scottish constitutional tradition.' This commitment is reiterated in the draft Bill: 'In Scotland, the people are sovereign'.

The Bill would be passed by the Scottish parliament following a Yes vote and the interim constitution it contains would take effect on 'Independence Day' in March 2016. This interim constitution would continue in force until a permanent written constitution for the State 'is agreed by or on behalf of the people of Scotland.' The Bill therefore sets out both the content of the interim constitution and also the process by which a permanent written constitution would be drafted following the Scottish parliament elections in May 2016.

Why is this important?

The interim constitution is important because we don't know when it would be replaced and because a number of its provisions may well find their way into a permanent constitutional document. Also, the very idea of a written constitution promises a significant constitutional break with the Westminster tradition. There are two big sets of questions.

- What would the final written constitution look like? Such a document would most likely entrench important principles beyond the reach of ordinary acts of parliament. This would inevitably hand more power to judges who would have the duty to interpret this constitution and to strike down the legislative will of parliament if an enacted law were found to be incompatible with the constitution.
- Who would draft this permanent constitution? Would the process be genuinely popular, or would it be controlled by elites?

The first question will determine what kind of country Scotland becomes; the second will determine the legitimacy of the entire process.

What does the Scottish Government propose the permanent constitution will look like?

In its White Paper the Scottish Government offered an extensive list of what it thinks the constitution should contain. A number of these provisions are key to its vision for independence and most find their way into the draft interim constitution:

- equality of opportunity and entitlement to live free of discrimination and prejudice (in the interim constitution although without any specific reference to prejudice)
- entitlement to public services and to a standard of living that, as a minimum, secures dignity and self-respect and provides the opportunity for people to realise their full potential both as individuals and as members of wider society (not in the interim constitution)
- protection of the environment and the sustainable use of Scotland's natural resources to embed Scotland's commitment to sustainable development and tackling climate change
- a ban on nuclear weapons being based in Scotland (the interim constitution contains a commitment to 'pursue negotiations with a view to securing... the safe and expeditious removal from the territory of Scotland of nuclear weapons based there').
- controls on the use of military force and a role for an independent Scottish parliament in approving and monitoring its use (there is no specific reference to this in the interim constitution, but it does commit Scotland to respecting international law and to promoting peace, justice and security)
- the existence and status of local government
- rights in relation to healthcare, welfare and pensions (not in the interim constitution)
- children's rights
- rights concerning other social and economic matters, such as the right to education and a Youth Guarantee on employment, education or training (not in the interim constitution)

The interim constitution also declares that Scotland is a 'constitutional monarchy' and 'the Queen is Head of State.' In the White Paper it was added that Scotland would remain a constitutional monarchy 'for as long as the people of Scotland wish us to be so.' This suggests that the head of state issue could be revisited in the process of drafting the permanent constitution.

It is notable that in the White Paper there was no commitment that a number of the proposed rights, such as the opportunity of education, training or employment and rights to welfare support and health care would be legally enforceable by courts but rather the more open-ended suggestion that they would be 'questions of social justice at the forefront of the work of Scotland's parliament, government and public institutions.' Notably, the rights do not find their way into the interim constitution at all.

The interim constitution also provides that the existing high courts, the Court of Session and High Court of Justiciary, will be in their respective areas of competence 'the Supreme Court of Scotland.' The interim constitution will seek to limit the powers of the Scottish parliament, preventing it from making laws that conflict with the European Convention on Human Rights or European Union law.

It is also anticipated that the interim constitution will ‘sit alongside’ a ‘refreshed and rewritten’ Scotland Act 1998 which will no doubt reiterate the human rights provisions in the Act, and will integrate the Human Rights Act 1998 into this renewed Scotland Act. At the same time, however, Schedule 5 of the Scotland Act will be removed, freeing the Scottish parliament from the constraints of those matters currently reserved to the Westminster parliament. It is anticipated that in due course there will be a permanent written constitution in which the supremacy of that constitution over the powers of the Scottish parliament is expressly declared. But until then, during the interim constitutional period, the Scottish parliament will operate through a regime of self-imposed legislative restrictions.

Drafting the Constitution: A Scottish Constitutional Convention?

The White Paper provides that, following the elections of May 2016, a constitutional convention will be established to ‘prepare the written constitution.’ This commitment is stated more firmly in the Scottish Independence Bill.

The White Paper did not tell us much about the composition of this convention, except that it would be ‘open, participative and inclusive’ and that the new constitution ‘should be designed by the people of Scotland, for the people of Scotland.’ The interim constitution also leaves the membership of the convention and its operational rules for the Scottish parliament to determine, including ‘the procedure by which the written constitution prepared by the Convention is to be agreed by or on behalf of the people.’ In other words, we don’t know yet if a referendum will be used to ratify a permanent constitution for Scotland.

The duty to establish a convention is a legally binding commitment within the interim constitution but since the Scottish Independence Bill, which would contain this interim constitution, is open to repeal in the same way as any other act of the Scottish parliament, it will not in fact bind the Scottish parliament should it later wish to delay this process or change how a new constitution is to be brought about.

The interim constitution and its explanatory notes don’t offer detailed prescription as to what the convention should look like, but we know from the White Paper that the Scottish Government has been looking at ‘international best practice’ and the practical experience of other countries such as citizen-led assemblies and constitutional conventions in British Columbia (2004), the Netherlands (2006), Ontario (2007) and Iceland (2010).

This raises the question: will the process really be a popular and meaningful engagement with citizens, or will it be a largely elite-led event, like the Scottish Constitutional Convention from 1989-1995? Will in fact the new constitution be drafted by elites – politicians, civic society organisations, business interests, trade unions and local authorities? There are significant democratic risks associated with constitutional conventions concerning how representative and how accountable they are. There is also the problem of such processes being open to the most vocal elements of civil society who can seize the opportunity to embed particular policy preferences in the constitution even those these may not enjoy the support of a majority of citizens.

In short, any move towards a permanent written constitution should be worked out very carefully to ensure that the process is genuinely democratic and deliberative.

What does the No side say?

The parties which constitute the Better Together organisation tend not to comment on the prospect of a post-independence constitution largely because they do not want to entertain publicly the prospect of a Yes vote. However, it is likely that all parties in Scotland would develop their own constitutional agendas in the event that Scots do indeed vote for independence.

The timetable set out in both the White Paper and the interim constitution makes clear that there would be time for this to take place. The constitutional convention would not be established until after the Scottish parliamentary election in May 2016. Parties would surely run in that election with manifesto plans for the constitutional process, setting out whether or not they agree with the constitutional convention route, and no doubt detailing their preferred constitutional design. And indeed it may well be that one or more of the parties which are currently campaigning for a No vote would in fact be in government to oversee the move towards a new constitution.

What do academics think?

Turning to the question of academic consensus on the issue, there is clearly general agreement that there would be a written constitution. In the event of independence, some form of foundational written document would be needed to replace the Scotland Acts of 1998 and 2012; even if an unwritten constitution were considered desirable, it is simply impossible today to replicate the conditions under which the UK parliament acquired its authority. The powers of the Scottish parliament and Scottish Government would require to be defined, as would the court structure, its hierarchy and the limits of its jurisdiction. There would of course be disagreement about what else should be in the constitution, particularly in relation to citizens' rights and entitlements.

Conclusion

The drafting process for a new constitution should engage with the general public as much as possible – taking seriously public opinion on a range of issues – so that the process is genuinely popular rather than elite-driven. But I am in general very sceptical of highly detailed written constitutions for the following reasons:

- Important decisions should be left to parliaments, so that people can use the electoral process to make key choices on policy matters. It seems very questionable that the first generation of post-independence Scots should take upon themselves the power to crystallise a broad range of current policy preferences as constitutional principles.
- By constitutionalising specific values and policies, the constitution would significantly ramp up the powers of judges, giving authority to a small unelected group which is arguably not entitled to determine these issues.
- Such a constitutional arrangement could be highly inflexible and potentially very difficult to change. Also, to declare so many things 'constitutional values' can curtail political debate. People who then criticise policies which have been dressed up as constitutional principles can find themselves accused of disloyalty to the country, which is deeply unhealthy for democracy.

Why not have confidence in the citizens of a new country to use their parliament to make the laws they want? If Scots are fit for self-government then surely they are competent to build their future through the rough and tumble of the political process. A final danger is that there could be huge controversy over the constitution if it becomes clear that it will micro-manage political and moral values. This could turn into a damaging battleground which would not be a good way to give birth to a new state, with winners and losers characterised as such from the very beginning; furthermore, the process could well be hijacked by the most vocal and best organised interest groups which again would be fundamentally undemocratic.

In my view this is all avoidable. In the event of independence a constitution will be needed, but why not start with a more modest constitution providing for a head of state, setting out the powers of the Scottish parliament and Scottish Government, the court structure, and local government? This would then leave it up to the people to exercise their newly gained independence through their parliament, allowing them to make the decisions they want, and from time to time to change their minds about these decisions should they wish to do so in an open and robust way.

And for big decisions there is of course the referendum; if it is appropriate to use a referendum to determine the independence question why not use it for other major decisions which Scots will make in the future?

Question 12: How different would or could Scottish social and welfare policy be from the policy of the UK in the event of either a Yes or a No vote?

Kirstein Rummery and Craig McAngus

The question

Scotland has always had a separate legal system and had control over much of its own welfare policy, such as local authority social care, for many years prior to devolution. As a result of devolution in 1999 many areas of social policy, including health, housing and local government fell under the remit of the Scottish parliament. However, critically, social security, fiscal and the bulk of economic policy, immigration and foreign policy are ‘reserved’ at Westminster.

Why does it matter?

International evidence suggests that a universal approach to public services and a commitment to equality, whether in legislation or as a constitutional aim, is an important step towards protecting vulnerable members of society. For example, countries with rights to access social care support services, provision of accessible transport and commitments to maintaining income replacement for those unable to work have a correspondingly good record in tackling disabled and older people's poverty. Similarly, countries which score highly on the European Gender Equality Index often have legal rights to childcare and equality of access to training, political and economic power, and education in their constitutions. ‘Universalism’ also facilitates social cohesion – if everyone is entitled to benefits there are no distinction between ‘welfare users’ and ‘welfare payers’ as it is assumed that everyone will both contribute to, and draw from, the welfare state. The success of the Nordic countries has been based upon this idea.

To tackle the link between poverty and social exclusion (for instance isolation or unemployment), countries need to be able to join up different parts of social policy. For example, they need to be able to control tax and social security policy to avoid low income families being ‘trapped’ in worklessness because it does not pay to work once travel, childcare, social care, taxation and loss of benefits are taken into account.

The current welfare reform and austerity policies, which apply to the whole of the UK, involve cuts to disability benefits, housing benefit, social care, child benefit, social security and others. This represents a sharp move away from universalism. Targeted and means tested benefits can theoretically tackle inequality more effectively than universal benefits. However, they also have the result of stigmatising welfare recipients – and the current language of ‘welfare dependency’ versus ‘hard working families’ makes it clear that Westminster favours creating disincentives to use state services and benefits wherever possible.

In the areas where Scotland has had control over social policy, there are some indications that it favours a universal over a targeted approach to welfare. Policies such as universal access to free personal care, free prescriptions, and free higher education are designed to create social cohesion, although, they do disproportionately benefit the well-off over poorer sectors of society. They are also designed to avoid the stigma associated with accessing welfare. So, what would

happen to Scotland's future welfare and social policies in the event of independence, and what would the outcome be if the referendum result said No?

What does the Yes side say?

There are some interesting commitments in the White Paper *Scotland's Future* – 'Independence will provide the opportunity to create a fairer, more equal society built around the needs of citizens' – but some important questions are left unanswered. There is a commitment that 'Social rights embedded in a constitution will put questions of social justice at the forefront of the work of Scotland's parliament.' The evidence suggests that small, economically strong states (particularly Norway, Denmark and other Nordic states) with both the principles of universalism built into their constitutions, and the mechanisms for delivering social justice tend to be more equal. The recently published Independence Bill does suggest wider involvement in the drawing up of a constitutional framework for an independent Scotland, but there is no detail about how this would be done.

Gender inequalities are recognised: 'the Scottish Government's recent analysis concludes that women will also lose out because of how the universal credit system in particular is structured' and 'restoring the ability of claimants to receive individual support rather than single household payments.. benefitting 880,000 individuals, many of them women.. and equalise the earnings disregard between first and second earners, which will be of particular benefit to women.' Women's economic independence plays a vital part in achieving equality, and their unpaid care is an important part of the economy. There are no proposals to recognise this although the expert group on Welfare Reform does recognise the value of unpaid care.

Childcare is an important part of the proposed changes to social policy: 'Extensive provision of early learning and childcare is a hallmark of some of the most advanced and successful countries today..' 'Independence... will... substantially bolster the financial case for a transformational change in childcare provision.' Investing in a 'universal system of high quality early learning and childcare' Moreover, a recognition that Scottish parents pay 27% of their household income on childcare as compared to the 12% average in OECD countries and that therefore 'independence will give us the opportunity to invest more in the supply of services rather than subsidising demand.' Research indicates that this commitment will result in better outcomes for children and working parents, will create jobs, create wealth that is spent in the local economy, address child poverty and lead to improved educational achievement.

Looking at wider issues, the commitment to abolishing welfare reforms that have been criticised as being stigmatising and divisive offers a possible step towards a welfare state that promotes universalism as opposed to simply providing a basic safety net. The Yes campaign has repeatedly stated that decisions about public spending priorities need to be made in Scotland to reflect Scottish priorities, values and needs. A commitment to creating a constitution and a welfare system built on the principles of social justice is important.

What does the No side say?

The three main pro-UK parties have now played their hands in terms of producing proposals for further devolution. Given that the Conservatives were hostile to the

very notion of devolution in the 1990s, their proposals go further than those from Labour, with the Liberal Democrats' proposals being the most far-reaching in terms of the devolution of tax powers. Although there are significant differences between the proposals, all the parties have placed the devolution of income tax as, arguably, the main pillar of their plans.

Labour – the UK as a 'sharing union'

Underpinning the party's proposals from its Devolution Commission is its notion that: 'The UK is a "sharing union," with economic, social, and political aspects, in which risks and rewards are collectively pooled... It also means we can share resources to permit social solidarity.' Although there are significant policy areas the party wishes to devolve, such as health and safety, the pillars of the British social security system (e.g. pensions, benefit payments, tax credits) must remain at Westminster in order to promote a UK-wide project of social justice.

On top of the 10p variability in the Scotland Act 2012, Labour proposes that the Scottish parliament should be able to vary income tax by 15p in the £ and there would be flexibility in which tax bands could be varied. This would give the Scottish parliament the capacity to increase income tax in order to boost spending on public services.

Conservatives – increasing the accountability of the Scottish parliament

Commenting on the 'unions' of 1707 and 1801, the Conservatives' Strathclyde Commission states: 'At root, each union had and still has – two fundamental goals: to create a larger economic market for jobs and enterprise and to assure the common security of everyone within the state.' Building on the economic and security advantages brought about by the wider UK, Scotland has the space to be different in terms of its institutional identity. The Scottish parliament is a key component of this but, as it stands, is not accountable enough because it essentially spends money without being responsible for raising it. As a result '...we have based our recommendations on strong Conservative principles of responsibility, transparency and accountability, which we believe are required for a sustained relationship of all four parts of the UK.'

Such thinking is the basis for the main proposal in the report: the full devolution of income tax. This would make the Scottish parliament directly accountable for a significant proportion of its budget. In terms of welfare, the Conservatives argue that the core of social security should remain at the UK level, stating that devolving pensions, for example, would undermine the UK's single market. However, the report contains an interesting, if somewhat vague, proposal to allow the Scottish parliament to 'supplement' benefits: 'Everyone in the UK – wherever they live – should be entitled to at least the social security provided for in UK legislation at Westminster. But, if the Scottish parliament were to take the view that, from its own resources, the UK entitlement should be supplemented in Scotland, it may be that Holyrood ought to be able to legislate accordingly.'

In this regard, the report goes further than Labour's proposals in that the Conservatives are quite comfortable with a Scottish 'top-up' on core welfare payments. Such proposals would give the Scottish parliament the capacity to

provide more generous welfare payments, but the likelihood is that income tax would have to be raised in order to pay for this.

Liberal Democrats – a federal UK

The Liberal Democrats have a long-standing commitment to a federal UK, and in many respects, particularly with regards to taxation devolution, their devolution report is the most comprehensive. Despite recommending that income tax, inheritance tax, capital gains tax and air passenger duty be devolved, the report sees social security as a UK-level competency: 'The Commission... endorses the retention of a single UK welfare and pensions system, supporting free movement and residency across the UK with a common set of living standards and entitlements.'

The justification for the UK retaining such competencies is similar to the Conservatives'. The taxation powers that the Liberal Democrats believe ought to be devolved would give the Scottish parliament some substantial fiscal levers through which it could raise extra revenues for public spending, but without powers over social security, the ability to create a distinctly Scottish system are limited.

In summary: our assessment of the arguments

The Yes campaign has made a persuasive case for a vision of social and welfare policy that is a departure from the Westminster model. Since 1999 there has been a move towards a commitment to universalism and social justice in principle and in practice, such as free personal care, free prescriptions, a commitment to no university fees, governance mechanisms like the Equalities and Budgetary Advisory group, domestic violence policy, and a commitment to end homelessness. But Scotland is still a divided society in terms of income, health, gender and other inequalities. If principles designed to tackle this are not enshrined in the constitution it will struggle to address this. A Yes vote would potentially offer the nation an opportunity to create a more socially just society than it would if it remained in the UK, but this depends heavily on the constitutional settlement that is agreed – not everyone in Scotland is committed to social justice and universalism.

If Scotland votes No, the path it follows will be largely determined by the 2015 UK general election. The devolution proposals will likely exist as manifesto promises and would thus be delivered on the basis of the proposing party winning the election and forming a majority in the House of Commons. However, there is a strong chance that the 2015 election will not produce a clear winner and so a single-party minority or coalition government is a realistic prospect – meaning that delivering a coherent set of proposals will no longer be in the gift of any party. Compromises may have to be made and/or reforms may be blocked.

The technical details of which welfare and social security arrangements will come about after a No vote remain to be seen. However, if Scotland does vote No, the central pillars of the social security system will stay at the UK level as there is little will from the pro-UK parties to further devolve this particular policy area.

Question 13: Does Scotland need a separate immigration policy? And if the vote is Yes could we have one?

David McCollum and Scott Blinder

Why does it matter?

Immigration is an area of policy over which Holyrood currently has little legislative control. Under the 1998 Scotland Act, which reinstated the Scottish parliament, the immigration system and border controls remained 'reserved' to the UK Government. But an independent Scotland would be likely to pursue a different set of policies from the present approach in the UK, so this is an issue relevant to the independence debate.

The UK Government has developed an increasingly restrictive stance towards immigration, arguing that too many people coming in has strained social cohesion and put pressure on wage levels and public services. In contrast, the Scottish Government wants to attract more migrants to Scotland – particularly the highly-skilled – for both demographic and economic reasons. It argues that it is prevented from doing so by the restrictive 'one size fits all' UK immigration regime. The White Paper, *Scotland's Future*, said 'Scotland has a different need for immigration than other parts of the UK... the current UK immigration system has not supported Scotland's immigration policies'.

It is therefore widely assumed that independence would lead to changes to immigration policy in Scotland. If it had the relevant powers, Scotland – at least under an SNP-led Government – would likely enact a less restrictive set of immigration policies than those of the current Westminster Government. On the other hand, Scottish Government proposals to remain within a passport-free Common Travel Area together with the rest of the UK and Ireland would require some level of negotiation with the two other governments, and this coordination could place some constraints on immigration policy even for an independent Scotland.

What does Yes say?

On the Yes side of the independence debate, the Scottish Government has argued that Scotland would benefit from the autonomy to make its own policy and has made a case for encouraging immigration, particularly highly-skilled workers. The Scottish Government has consistently said that more immigrants could be a key driver of both demographic and economic growth in Scotland. Its official Population Target aims to match population growth in Scotland with the average for the European Union over the period 2007-2017. Scotland has a modest rate of natural increase of population (births minus deaths), so migration is the primary means through which this target can be achieved. Most of Scotland's gains from immigration come from international migration, as opposed to inflows from the rest of the UK. This means that immigration policy has a significant bearing on population change in Scotland.

The arguments put forward for Scotland meriting a separate policy appear credible given Scotland's historical net losses of population through emigration, a relatively small migrant population today and reliance on migration for demographic

stability. These demographic trends mean that Scotland ‘needs’ migrants to a greater degree than many other parts of the UK. Scotland has traditionally lost more people than it has gained from migration, meaning that its foreign-born population (7%) is smaller than the UK as a whole (13%). Despite having a relatively small migrant population, a low rate of natural increase means that Scotland is much more reliant than other parts of the UK on immigration in order to keep its population stable or growing. Scotland’s population is also ageing more rapidly than the rest of the UK’s, meaning that immigration may play a particularly significant role in boosting the population of working age people relative to retirees.

As well as immigration being desirable for demographic reasons, the Yes side argues that Scotland is politically relatively well suited to an immigration policy that seeks to attract and retain migrants. Attitudinal surveys indicate that the general public in Scotland is less hostile to immigration than is the case in other parts of Britain (aside from London). So whilst an argument could be made that immigration benefits the UK generally, the public in Scotland may be more tolerant of policy efforts to attract migrants than is the case elsewhere. This is particularly true for high-skilled labour migration and for international students, two of the migrant groups that raise the fewest objections from members of the Scottish (and English and Welsh) publics.

But while Scotland appears to be more welcoming than England, surveys show that a majority of Scots still support reduced immigration. This sentiment could become more prevalent and vociferous should the Scottish Government be successful in its efforts to increase levels of immigration to Scotland, or if, in an SNP-led government, opposition parties began to campaign more strongly for restrictions on the number of people coming into the country.

A final point in favour of Scotland having a separate immigration policy is the view that UK policy is driven by the perceived ‘overheating’ of London and the South East of England. Restrictive immigration policies, as a consequence, may suit those regions but have negative demographic and economic impacts for other parts of Britain. The Scottish Government would argue that independence would give Holyrood the policy levers required to pursue immigration policies that are better suited to Scotland’s particular economic and demographic needs. Opinion polls have shown that there is widespread public support for Holyrood rather than Westminster as the key decision-making body for immigration policy (60%) and asylum policy (58%) for Scotland.

What does No say?

Whatever the outcome of the referendum, Scotland will face some significant challenges in terms of developing a more autonomous immigration policy. On the No side of the argument, the UK Government has expressed scepticism about Scotland’s demographic and economic case for increased migration, but has focused more on the difficulties of implementing a more open immigration system in an independent Scotland that shares a border with the rest of the UK, and the potential clash with UK interests and preferences.

In particular, the No case highlights tensions between an independent Scottish immigration policy – particularly one aimed at population growth – and the stated intention of the Scottish Government to remain within the Common Travel Area

(CTA) that currently binds the whole UK with Ireland (as well as the States of Jersey and Guernsey and the Isle of Man) in a 'borderless' zone in which people are free to move without routine passport checks. The CTA is similar to the Schengen area that includes much of the EU, although it is less formal and not based on a treaty among its members. The White Paper, however, makes it clear that Scotland would pursue EU membership but not Schengen membership, as it would prefer to remain in the CTA. It is not possible to be in both the CTA and Schengen.

An independent Scotland may therefore face practical, political constraints on its ability to make its own immigration policy from both the EU and the UK. The UK Government's position is that an independent Scotland, if it remained in the CTA, would need to co-ordinate migration policy with the rest of the UK and Ireland. The UK Government's *Scotland Analysis* paper on borders and citizenship asserts that: 'It is simply not possible to collaborate with other states in a borderless travel arrangement and at the same time to have an immigration policy that differs significantly from, or undermines the policies of, the other members.'

Is there a consensus in expert opinion?

There are informed, expert views to consider on each of the issues raised above – and areas of more or less agreement. It seems clear that Scotland indeed differs from England in its demographics, economic situation, and public attitudes toward migration (though London is an exception in England). It is also clear that independence would shift formal power over immigration policy in Scotland from Westminster to Holyrood, although it can be argued that there is room for Scotland-specific policies on immigration even without independence.

Several points are less clear. First, there can be disagreement about how much immigration policy can do to boost the Scottish economy and compensate for its ageing population, especially in the long-run. It is generally agreed that migration adds to growth, but some studies have found it reduces wages for low paid workers, and can increase unemployment during periods of recession. Migration may help the problem of an ageing population, but expert analysis suggests it is not a complete cure. It can be difficult to control the number of people coming in and the number of people leaving the country cannot be controlled. Internal movement, within the country, can also shape the impact of migration on existing populations and infrastructure. If immigration was at a level sufficient to reverse population ageing, it is likely to run into political and other practical difficulties.

A second point of contention surrounds the CTA, and how much an independent Scotland would have to harmonise its immigration policy with the rest of the UK and Ireland. This would be the outcome of political negotiations that cannot be predicted in advance. The UK Government has warned that it would attempt to limit the differences in immigration policies across the CTA, including an independent Scotland. In particular, the UK regards an immigration policy aimed at population growth as against its own priorities and suggests that if pushed far enough this could lead to a decision to set up a border with passport controls between Scotland and England.

On the other hand, the Yes side has pointed out that a 'hard' border of this type would be against the interests of the UK as well as Scotland, and so might be too costly a step to take or credibly threaten. It has also been argued, even within the

UK, Scotland could operate a more distinctive immigration policy by varying the incentives allowed in the present points-based system to encourage high-skilled migration to Scotland. So the likely level of autonomy for Scotland's migration policy is not fixed but would be the outcome of political negotiations, either in independence or in continued union. In any case this discussion could all be moot if the EU insisted that Scotland join the Schengen area as a condition for EU membership for Scotland (Schengen membership would preclude ongoing CTA membership). Most commentators assume that this is not likely.

Finally, the politics of immigration policy have a bearing on the Yes and No arguments. The Yes side anticipates a more open immigration policy, and touts the higher levels of tolerance among the Scottish public. This is true, but only to a point. Immigration is less of a political issue in Scotland than in England – there is a less heated political debate and negative views of immigration are not as widespread. However, most Scots still say they would prefer less immigration (although only a minority wants a reduction in highly-skilled workers and international students coming in). But would the current, relatively mild state of political debate continue in an independent Scotland that is responsible for immigration policy-making? If the government enacted more open immigration policies, there would be strong political incentives for opposition parties to attack these policies in an effort to gain support from voters who prefer less immigration.

Assessment

Overall, the case that Scotland would benefit from a different, autonomous immigration policy has considerable merit: Scotland's situation is different, both economically and demographically. Migration is not a panacea in either case, but it can contribute to growth and to mitigating population ageing. And a majority of the Scottish public prefers Holyrood to Westminster as the key decision-maker on migration and asylum policy. On the other hand, membership in the CTA may limit the autonomy of immigration policy even in an independent Scotland; the outcomes of negotiations are unknowable, but the UK Government would push back against policies designed to increase immigration numbers. So an independent Scotland trying to meet economic and demographic aims through migration policy would have to deal with constraints from CTA (and/or EU and Schengen) membership and potentially from its domestic politics as well.

Finally, it is conceivable that even if it were to continue as part of the UK, Scotland's distinct situation could be still accommodated through using flexibility in UK immigration policy.

Question 14: What would happen to pensions in the event of a Yes or a No vote?

David Bell and David Eiser

Introduction

The Scottish Government has been keen to stress that pension rights and benefits will not be affected by independence. Its desire to reassure people is understandable – pensions are among the most important financial contracts that individuals enter, and people in Scotland will be keen that they receive the rights and entitlements that they have built up – whether these are rights to the State Pension built up through National Insurance payments or contributions to an occupational scheme.

It is useful to distinguish between three types of pension:

- The State Pension, which is a payment to all those of pensionable age, with the payment depending on National Insurance Contributions (NICs) made over the lifetime;
- Public sector pensions (workplace pensions for those who have worked in the public sector); and
- Private sector pensions.

There is no obvious reason why the conditions around any of these should change radically on independence. The Scottish Government plans to keep the State Pension largely in its current form (although with a couple of minor changes – making it slightly more generous for certain people and temporarily delaying the increase in the State Pension age). Most public sector pensions in Scotland are already managed as Scottish (rather than UK) schemes.

The main long-run pension challenge is their affordability as the population ages. This is a challenge regardless of the constitutional position, although it is slightly more acute in Scotland than in the rest of the UK. The affordability issue is perhaps more likely to result in higher contributions for current workers (and taxpayers) than for pensioners themselves. Adjusting pensions already being paid is usually a last resort. There are also some issues to resolve about how existing pension liabilities might be split between Scotland and the continuing UK. Finally, there is an important question about who would provide pensions, given that one of the great strengths of Scotland's financial sector is its pensions companies.

What will happen to the State Pension if there is a No vote?

The State Pension is an important source of income for pensioners. The average State Pension payment is £130 per week in Scotland, approximately the same as in other parts of the UK. The State Pension is a major component of total government spending, costing £6.8 billion in 2012/13 in Scotland, equivalent to around 40% of all spending on benefits and tax credits, and 10% of total public spending for and on behalf of Scotland. Changes in State Pension policy can thus have important implications both for pensioners and for the public finances.

The State Pension age for men is 65; for women it has traditionally been 60 but since 2010 it has been increasingly gradually and will reach 65 in 2018. Between 2018 and 2020 the pension age for men and women will increase to 66, and to 67 by 2028.

What will happen to the State Pension if there is a Yes vote?

The Scottish Government has been keen to stress that there will be little upheaval in arrangements for the State Pension, should Scotland become independent. However, it does outline a number of areas where policy in an independent Scotland may differ from that in the UK.

- A delay in the rise in the pension age to 67 until 2034. Between 2028 and 2034, people in Scotland would be entitled to the State Pension one year earlier than people in rest of the UK.
- Retention of the Savings Credit element of Pension Credit – an income-related benefit top-up for pensioners on low incomes who have saved some money for their retirement. It currently benefits 9,000 pensioners in Scotland to a maximum of £18 per week. The UK Government plans to abolish this credit after 2016.
- An increase to the Single Tier Start Rate (the Single Tier Pension is a simplified state pension system based on 35 years National Insurance contributions which will be introduced in 2016), which would be set at £160 per week in Scotland, £1.10 higher than in the UK, and will be uprated each year by the so-called ‘triple-lock,’ which means that the state pension will increase by the maximum of: (i) the increase in earnings; (ii) the increase in prices or (iii) 2.5%, whichever is higher.

These policy proposals are costly. Delaying an increase in the State Pension Age is particularly costly for the public finances, as it means reduced revenues from labour taxes and increased pension payments. The Scottish Government has claimed that the delay is affordable because life expectancy is lower in Scotland – pensions cost less in Scotland because people on average die earlier and so do not receive them for so long.

However, a more relevant question is to consider spending on the State Pension relative to the working age population, because the working age population pays the taxes which fund pensions. Between now and 2035, Scotland’s population is projected to ‘age’ more quickly than that of the UK. Ignoring the effects of the policy change discussed above, spending in Scotland on the State Pension will, by 2035, be around £400 million higher than if Scotland had the same age distribution as in the rest of the UK. This is equivalent to a cost of £142 per working age individual in Scotland.

The UK Department for Work and Pensions has estimated the costs of the State Pension proposals in the White Paper at an additional £1 billion per year by 2032. Their impact is to increase the size of Scotland’s State Pension funding gap, relative to the working age population, by a further £210. (The most costly policy proposal is the delay in the age increase, which is estimated to cost £0.8 billion, but only applies for the years 2028-34). So while the State Pension might be more generous in an independent Scotland, the revenues to pay for this will have to be found either through taxes or reduced government spending elsewhere.

It is likely to be administratively difficult to establish whether those receiving the state pension built up their National Insurance contributions in Scotland or in the rest of the UK. This is clearly important in determining where the liability for State Pension payments lies. If the data is unavailable, some rough rule of thumb is likely to be negotiated, such as the liability for paying the State Pension lying with the

country in which the pensioner is resident. Determining who would be liable for payment of the pensions of the 1.1million UK pensioners who live abroad would be even more problematic.

Public Service Pensions

Around one million people in Scotland currently have a direct interest in one of the five main public service pension schemes (for teachers, NHS workers, local government, police, and the fire service). either as members, as pensioners or as dependants. In 2009/10, the five schemes paid out £2.8 billion to pensioners while public bodies contributed £2.2 billion and employees paid £814 million to meet their expected long-term costs. There are both funded and unfunded public service pension schemes in Scotland. The Local Government Pension Scheme is the main funded scheme (where payments are financed out of the contributions that pensioners themselves made when they were working); the NHS, teachers, civil servants, police and fire-fighters' pensions are all unfunded (pensions paid to current pensioners are financed from contributions paid by current workers).

Whether Scotland becomes independent or remains in the union, the key challenge is the affordability of these schemes. Prior to the recession in 2007/8, the Scottish pension schemes received more in contributions than they paid out to retirees. This position then deteriorated, and in 2011/12 these schemes (funded and unfunded) paid out over £300m more than was received. This trend reflects a reduction in returns on investment, combined with real terms increases in payments which have not (for unfunded schemes) been equally matched by an increase in contributions.

The five schemes are already managed as separate Scottish pension schemes, and thus arrangements for their management are not expected to change radically on independence. But most shortfalls in the unfunded schemes in any given year are met by the UK Government and thus funded by UK-wide taxation. Scottish taxpayers will obviously become fully responsible for such shortfalls should Scotland become independent.

Public sector pensions form a major part of government's future liabilities. In fact, public sector pensions are the largest UK liability, accounting for £1 trillion of the UK's total of £2.6 trillion. Scotland is exposed to broadly its population share of public sector pension liabilities (about £86 billion). However, as there are no separate civil service or armed forces schemes in Scotland, negotiations would have to take place around how the UK's liabilities for these pensions might be split on independence. The liabilities do not reflect the pension that may be paid to current employees for any further years of service that they may add or for future employees. Hence it represents only a partial assessment of how pensions will affect the public finances in the future. Nonetheless, the value of these pensions clearly adds to the overall indebtedness of the public sector.

The issue of meeting these pension commitments is not directly related to the constitutional issue. It will arise irrespective of the referendum outcome. Public service pension schemes should broadly balance, in other words the employee and employer contributions over a period of time should match payments to pensioners. Throughout the 2000s, the expansion of public sector employment helped keep public service pension schemes solvent. A shrinking public sector could pose major

challenges to the funding of public pensions, particularly those that are ‘unfunded,’ for which current payments are met from current contributions. Shortfalls in such schemes could be met either by increasing current contributions (from employers, employees, or both), or through general government revenues.

Filling a gap through general government revenues would imply an increase in taxation or reduction in spending on public services. Either would involve a redistribution of revenues from the general population to public sector pensioners. Scotland has a slightly higher proportion of public sector workers than the rest of the UK (25.6% v. 23.1%) and this explains its relatively larger liability (relative to its population share of 8.3%) for unfunded schemes.

Occupational Pensions

The White Paper states that ‘Occupational and personal pension rights and accrued benefits will not be affected by Scotland becoming independent.’ The Scottish Government proposes to continue policy to encourage private pension saving, including the roll-out of automatic enrolment.

But there are important questions around how pension fund assets held by Scots might be invested in government bonds, and the implications for returns. This is especially the case if Scotland were to adopt a separate currency.

Pensions are funded by purchasing assets which earn a return. Because they produce a safe and predictable return, government bonds almost always form part of these assets. While pension funds may hold bonds from a number of countries, they tend to concentrate on holding domestic government bonds. This is likely to be a market that pensions companies understand well and where there is no risk associated with currency fluctuations, which might be the case with foreign government bonds. Our analysis suggests that in 2013, Scots held around £165 billion of pension fund assets, of which around £44 billion was held in UK Government bonds.

However, these funds are held by UK pension companies on behalf of all their UK customers: any distinction between Scots and rest of the UK fund members is not relevant at present. After independence, the existing contracts would presumably be honoured. But if an independent Scotland adopted its own currency, Scottish pensioners might gain or lose depending how this currency fares in relation to sterling. This would likely raise difficult legal issues, given that the pension contract was initially made in sterling.

For those currently investing in a pension, the market for Scottish Government bonds would be more relevant. The Scottish Government will need to sell such bonds immediately post-independence in order to fund its public services. If Scotland is still part of a currency union, these bonds would have to be more attractive than UK bonds in order to attract pension fund buyers. This might require that Scottish bonds offer a higher rate of return than UK bonds, and this may be the case if the Scottish Government faces a higher rate of borrowing on its debt than the UK Government does. This ‘liquidity premium’ may allow Scottish pension funds to purchase a larger fund for retirement than UK counterparts. If Scotland had its own currency, it is less clear that there would be any dividend for Scottish pensions and there would certainly be debate about the implications of receiving a pension in a foreign currency.

Conclusions

In the case of a Yes vote, the Scottish Government has indicated that it would provide a slightly more generous State Pension, and delay the UK Government's planned rise in the State Pension age to 67 by around eight years. The more generous State Pension will affect the affordability challenge posed by an ageing population and would have to be funded through general taxation.

Affordability will also be affected by the fact that Scotland has a higher proportion of public sector workers and a more rapidly ageing population. Under current arrangements, shortfalls in Scotland's unfunded pension schemes are met through UK taxation, whereas under independence, shortfalls would clearly have to be met through Scottish tax receipts alone.

For both the State Pension and UK-wide public sector pensions (civil service and armed forces pensions), independence would trigger the need for discussions between the UK and Scottish Governments as to how to split liabilities for pensions for people who have accrued entitlements in a different state from the one in which they retire.

For those investing in occupational pension schemes, the prospect of an independent Scotland adopting its own currency raises issues: Scottish pensioners who had invested in UK schemes may find the value of their pension fluctuating depending on the exchange rate between sterling and the new Scottish currency. On the other hand, independence may enable Scottish workers to secure a larger pension fund for their retirement, if the Scottish Government has to pay more to borrow than the UK.

The funding of state and public sector pensions will be difficult whatever the constitutional outcome. The Scottish Government has been keen to stress that pension arrangements will change little if at all under independence. Nonetheless, although conditions may not change much for pensioners, the challenges posed by an ageing population are likely to require some combination of increased contributions and/or general taxation in order to fund existing liabilities. Although this challenge will exist whatever the constitutional position, the affordability challenge is likely to be more acute for Scotland than it is for the rest of the UK.

Business & competition



Question 15: Would a Yes vote be good for business? Would a No vote?

Brad MacKay

Why is it important?

One of the most important determinants of any country's future economic prosperity, and a key battleground in this referendum debate, is what constitutional arrangement is better for business competitiveness and growth. The Yes side argues that having more powers to tailor economic policy to the needs of Scottish business will help to enhance productivity and growth. The No side argues that the success of Scottish business is underpinned by the scale of the UK single market. Understanding the implications of the referendum debate for business can therefore be an important guide to the economic consequences of the vote, and its implications for employment, Scotland's fiscal position, and its wealth creating potential.

About three-quarters of Scotland's employment is in the private sector. According to Scottish Government statistics, small businesses (0-49 employees) account for 98.3% of the 343,105 private sector enterprises operating in Scotland, they make up 42.3% of private sector employment and generate 23.6% of private sector turnover. The 2,270 large businesses operating in Scotland, by contrast, only make up 0.7% of the total number, but account for 45.3% of private sector employment, and crucially, generate 63.3% of private sector turnover. How the vote impacts on business decisions to invest, re-invest, expand, withdraw, locate or relocate business activity within or outside Scotland, therefore, is critical for Scotland's economic prospects following the referendum.

What the Yes side says

The Scottish Government argues that Scotland has a highly skilled workforce, world-class businesses, an internationally recognised brand, a reputation for innovation, and substantial natural resources. It suggests that industrial manufacturing has suffered decades of neglect. The UK economy, it says, is dominated by London and the South East. Many of the policy levers for creating jobs and wealth in Scotland are reserved powers for Westminster. They state:

‘Control of taxation, public spending limits, regulation of business and industry, and competition policy all rest in London. Successive devolved Scottish governments have had considerable success in reducing unemployment, increasing employment and promoting inward investment. But the fundamental economic decisions that affect Scotland are taken in Westminster, often by governments that have no popular mandate in Scotland, and in the interests of an economy and society with different priorities from Scotland.’

Independence, the Scottish Government maintains, will allow it to reduce Air Passenger Duty by 50%, business rates for small businesses, and corporate tax by three percentage points to counter the gravitational pull of London and the South-East. Compliance costs for business will be reduced through a simplified tax system,

and, combined with greater control over immigration and capital investment in infrastructure, will improve productivity. Links between businesses, funding providers, public sector agencies and universities will be improved with a coherent strategy and shared priorities. A package of employment measures designed to enhance employee representation and female participation on company boards and to create cohesion and opportunity in the workplace will help to improve fairness and company performance. The economy will be rebalanced through policies to improve innovation and exports and re-industrialisation. They argue:

‘An independent Scotland will have the opportunity to pursue policies designed to grow the economy and create jobs. With responsibility for the full range of policy levers, the government of an independent Scotland will be able to create a more supportive, competitive and dynamic business environment.’

In addition, they maintain that: Scotland will be a member of the EU at independence; it will be in a monetary union with the UK, and share the pound Sterling; there will be a single energy market, joint procurement for defence contracts, and funding councils for universities will be shared between the two countries. The Yes side views independence as the business opportunity of a lifetime. The Scottish Government believes that the policy levers available to them with independence would allow them to transform the economy through policy choices that better reflect the priorities of Scottish households and businesses, and to create a fairer society.

What the No side says

The UK Government argues that Scotland has flourished as part of the UK; it is one of its wealthiest parts. Scotland’s economy has outperformed many small independent European states. The UK, they maintain, is one of the most integrated single markets in the world, and Scottish businesses have become successful within that policy and regulatory context. Scotland’s strong sectors in defence, energy and financial services rely on the UK market where a majority of their trade is. As part of the UK, Scottish businesses have a market of 63 million people. An independent Scotland would have a population of 5.3 million. They argue that some 70% of Scottish exports go to the rest of the UK. In addition, goods, services and people can move freely throughout the UK. Furthermore, business and consumers benefit from the stability of the pound, shared institutions, regulations, infrastructure and a single labour market. Costs and investment in, for instance, energy, are shared by the UK as a whole. Moreover, costs for businesses and consumers are kept lower by the reputation of UK institutions and the scale of the UK. They argue:

‘As it stands, the UK is a true domestic single market – with free movement of goods and services, capital and people. Businesses are able to trade freely across the whole of the UK; consumers benefit from a greater number and variety of goods and services at lower prices; and workers are able to access a greater number of jobs allowing them to maximise their skills and realise

their range of aspirations. It is one market with no internal barriers to the flow of goods, capital and labour.'

If Scotland were to become independent, the UK would co-operate in areas of mutual interest, as it does with other independent states. There would not be a monetary union with a shared currency with Scotland. Scotland would have to support its own financial sector during crises. Scottish businesses and consumers would no longer benefit from the same borrowing rates available to the UK. Scottish firms would no longer be eligible for bidding on contracts from the UK Ministry of Defence (MoD). Costs and investment in, particularly, energy, would no longer be spread across the UK as a whole, but borne by Scotland. Scotland would have to set up its own funding councils for universities. Trade might also be reduced by 'border effects' caused by trade barriers between the UK and Scotland. They say:

'The UK's shared business framework helps drive growth and competitiveness across the UK, and is at the centre of Scotland's success in creating businesses that can compete on the world stage. This UK-wide framework and guaranteed access to the whole of the UK's domestic market, underpins Foreign Direct Investment in Scotland.'

They conclude that Scottish business has the best of both worlds: they have the benefit of the size and strength of the UK, *and* they are also supported by the focused and targeted efforts of the Scottish Government using devolved powers.

Is there a consensus expert opinion?

Evidence from independent, politically-neutral studies of business leader's attitudes towards the independence debate is relatively consistent. It is the uncertainty over and above the normal business uncertainty that business leaders are used to dealing with, and have an understanding of, which poses the largest challenge for businesses. The most problematic issues for businesses are the currency (with a strong preference for the pound Sterling), regulation, corporate and personal taxes, EU membership (with a strong preference for remaining in the EU), the business environment and the costs of a transition period. The vast majority of businesses indicate that independence poses significant risks to their business operations and strategies. The risks expressed by business leaders are highly specific and directly concern business activity.

When asked about what opportunities independence might present, on average, research shows that only half of respondents in studies into business attitudes towards independence are able to identify opportunities. Of those they do identify, they tend to be less specific or unspecific compared to risks, and they tend to relate more to the economics and politics of the debate. The other half of respondents cannot identify any opportunities that independence would present for their businesses. Only a very small minority can identify where independence might present an opportunity for business growth.

A large majority of business leaders indicate that the costs and risks of independence to business outweigh the perceived benefits and opportunities that might occur. Unsurprisingly, large 'PLC' companies headquartered in Scotland

appear to be more affected than companies headquartered outside of Scotland. Companies supplying to the MoD also report that independence could pose a challenge to their business prospects. A significant number of medium and large companies have the majority of their trade in the rest of the UK (typically 90% and 10% in Scotland), and appear far more affected than companies whose trade is mainly in Scotland, or is diversified globally.

Medium-sized, privately owned companies appear more willing to absorb downside risk than PLCs, which are also concerned about shareholder value. Medium-sized, foreign-owned companies trading predominantly in a global market indicate they are less affected by the constitutional debate than PLCs trading primarily in the rest of the UK.

Business leaders of smaller medium-sized, private companies exporting globally, and smaller firms whose trade (both customers and suppliers) is predominantly in Scotland are the most likely to emphasise the opportunities presented by the possibility of Scottish independence.

Studies consistently show that up to 10% of business leaders indicate they may move business activity out of Scotland in the event of a Yes outcome.

The consensus of expert opinion, primarily based on the views of business leaders themselves, is that the risks posed by independence for business outweigh any opportunities it might present. While some, primarily smaller businesses might benefit from more tailored policy by an independent Scottish government, for the majority of successful companies in Scotland today, their success has been achieved within the policy and regulatory context of a highly integrated UK single market. If this changes, so does the foundations on which their success has been built.

Assessing the arguments

So what can we conclude from the evidence? The case for business really depends on what might materialise in negotiations following the referendum. If negotiations are complicated and the transition to independence is costly, confusing and lengthy, and if the Scottish Government is unable to deliver a deal on currency, uninterrupted membership with the EU, and removing Trident from Faslane, up to 10% of businesses indicate in various studies that they could take capital, business activity and head office operations out of Scotland. Foreign companies looking to invest in Scotland would also likely defer those investments until Scotland's economic future became clear. This could result in a significant reduction in economic output in the short term, and damage Scotland's economic prospects in the medium term. While as a smaller country Scotland might become more flexible and nimble, it would lose scale. Ambitions to reindustrialise the country would take time, and it could take decades to recover the lost economic output assuming that a higher rate of growth in Scotland could be achieved following its transition to independence.

On the other hand, if negotiations were relatively consensual and the transition to independence short, if the Scottish Government was able deliver a deal on the currency, if it was able to negotiate continuing and uninterrupted membership in the EU, if issues such as Trident were accommodated in the negotiations, if Scottish universities were able to maintain the same level of funding as they currently have, and if trade during this transition period was to be relatively uninterrupted, some of the risks to business might be mitigated. There would likely still be some loss of

economic activity in, for instance, industries like financial services and some headquarters of larger industrial companies out of Scotland, and this would likely result in a drop in private sector economic output and employment, however modest. But it might be recovered relatively quickly assuming Scotland could achieve a higher rate of growth following independence.

Clearly a No vote in the referendum also carries with it uncertainties. Of those cited by business leaders in samples and surveys, the most common tend to be the possibility of an 'in-out' referendum on the UK's continuing membership in the EU, domination of the UK by London and the South-East, the prospect of future referendums, or 'neverendums,' the fiscal position of the UK as a whole, lingering divisions between camps following the vote and scepticism about whether commitments of more devolved powers to Scotland will be honoured. Some business leaders also point out that the devolved powers coming into effect with the Scotland Act 2012 also pose uncertainties if, for example, tax rates in Scotland diverge from those in the rest of the UK, and the complications that could create for the business environment. While such uncertainties also pose risks to businesses, they are relatively specific and understood, and therefore manageable.

Question 16: What would independence mean for energy markets?

Grant Allan, Patrizio Lecca, Peter McGregor, Kim Swales

Why is this important?

Energy is essential to support modern industrial and domestic activity. Disruptions to power supplies can harm peoples' lives and the price that people have to pay affects their standard of living. The price of power impacts directly on the competitiveness of businesses in Scotland, and so on the level of output and employment. The way in which energy is used and generated across the world has a major impact on global warming, which constitutes a long-term threat to the population of Scotland, for example, in the form of increasingly extreme weather. Finally, the energy sector is itself an important source of economic activity – of employment and incomes in Scotland. The energy sector is expected to grow and generate additional economic activity.

The Scottish Government has a number of policy aims:

- to ensure *security of supply* – to 'keep the lights on;'
- to try to ensure the *affordability* of energy (and to limit fuel poverty);
- to improve the *environment* and combat Climate Change by limiting emissions and leading by example;
- to exploit the *economic growth* potential of the energy sector, especially in terms of renewables, as it seeks to move towards a low carbon economy.

The promotion of renewables, the resistance to new nuclear generating capacity and the adoption of legally binding climate change targets are examples where successive Scottish administrations have used devolved powers to pursue a distinctive Scottish energy policy. However, many key aspects including market regulation and taxation, are, under current constitutional arrangements, beyond the control (though not necessarily the influence) of the Scottish Government.

What does Yes say?

The Yes campaigners argue that:

- The integrated British market in electricity and gas will be maintained and operate pretty much as it does now, but with the Scottish Government having a bigger say in its operation. Scotland will therefore continue to be a major exporter of electricity to the rest of the UK. (Currently around 25% of output is exported, and the Scottish Government expects this share to grow significantly.)
- The UK Government will continue to import electricity generated in Scotland on similar terms to those that currently prevail because it will be in its own interest to do so, since it would otherwise experience a problem of security of supply and be unable to meet its legally binding EU emissions targets for 2020.
- Scottish residents would not contribute to the costs of the new nuclear provision.
- The EU targets for 2020 will remain as they are for the UK as a whole.

- Additional Scottish Government powers over energy policy will facilitate growth of the energy sector.

What does the No side say?

The No campaigners take the view that:

- There will continue to be an integrated network, but transactions will be subject to new, and purely commercial, contracts. Scotland may still export electricity to the rest of the UK, but these exports will not be privileged and will be dependent on competitiveness.
- The rest of the UK is not dependent on Scottish imports for security of supply, they constitute less than 5% of total consumption.
- The rest of the UK will be able to meet its EU targets without importing electricity from Scotland.
- Existing payments of Renewable Obligation Certificates (ROCs) would cease, and Scottish renewables output would be subject to an uncertain price.
- Scottish residents will be hit by a dramatic hike in energy prices as the whole of Scottish renewables investment and production will have to be funded entirely by Scottish taxpayers.
- The EU emissions targets for 2020 will have to be renegotiated and this is likely to result in Scotland being subject to tighter targets, and the rest of the UK's targets being reduced.

Is there an expert consensus?

A number of expert views have been offered, but there is no consensus and there has been no systematic attempt to assess the impact of independence on the ability of the Scottish and the rest of the UK Governments to meet their energy policy goals. We now seek to address that gap.

Security of Supply

There is a range of ways that the rest of the UK could address this issue, reflected in ever tighter capacity margins – and to some extent already is – by expanding generation and interconnector capacity south of the border (induced in part by government support), importing fuels, notably gas, and investing in new nuclear generation. So, it seems difficult to argue that the rest of the UK is a 'captive market' for Scottish electricity. However, given the timescales required to alter generation and interconnector capacities (for example nuclear cannot come on line until 2023), imports from Scotland are likely to form part of the rest of the UK's solution in the short and medium runs.

Longer-term the rest of the UK could no doubt make arrangements that would ensure its standalone security of supply. It is looking at the whole range of technologies, including nuclear and large scale biomass, although there is recent shift against renewables, and are implementing technologies that will facilitate demand side management policies (notably smart meters).

Overall, there is a security of supply issue for the rest of the UK, but the Scottish Government overstates the dependence on Scottish exports, at least over the longer term. From the perspective of the UK as a whole it would be extraordinarily

inefficient for Scotland and the rest of the UK to address security of supply issues separately.

Climate change, emissions and renewables

The Scottish Government has adopted very ambitious, legally binding targets for cutting emissions (42% by 2020 and 80% by 2050 on 1990 levels). The long-term decarbonisation of the electricity generating sector is a key element of Scottish Government's climate change policy despite contributing nothing immediately to its emissions targets. The main types of policies that impact on emissions are: the price of carbon; the promotion of renewables, and the encouragement of greater energy efficiency.

Yes camp

The Scottish Government argues that current market arrangements will continue, including the sharing of the cost of renewables development, and of new infrastructure. The UK looks to be struggling to meet its legally binding EU target, even with Scotland's substantial contribution. So, in effect, the rest of the UK will have little option but to continue to purchase 'green energy' certificates from renewable electricity generation in Scotland and effectively continue to subsidise generation here.

No camp

The Department of Energy and Climate Change believes that after independence the cost of renewables development will fall entirely on Scottish consumers, so that prices to Scottish consumers would have to rise dramatically above those charged in the rest of the UK. Such would be the scale of the increased charges that there would inevitably be a question mark over the feasibility of achieving Scotland's climate change and renewables targets.

Assessment

The Scottish Government's claim of the rest of the UK's dependence on Scotland to meet its binding emissions targets may be exaggerated, although other options prior to 2020 may be fairly limited. Other domestic options may be more attractive post-independence, including developing offshore windfarms and importing more. The rest of the UK could also choose to trade in green certificates (eg with Ireland) to meet its EU targets.

The UK Government exaggerates the threat of independence to Scottish renewables. In terms of the contribution of Scottish renewables, an independent Scotland could pursue policies that would ensure meeting its ambitious 2020 renewable energy target of production equivalent to 100% of Scottish consumption. But the costs would increase electricity prices by around 7.5%.

Affordability

While the aspiration to make energy 'affordable' may be laudable, the Government of a small, open economy like Scotland has limited control over this to the extent that energy prices depend on the cost of imported fuels. Further, since fuels are a declining resource the projected trend of their relative prices is upward. Of course,

the move to decarbonisation reduces that reliance through time. In fact, the Scottish Government also has more demanding targets than the UK to reduce fuel poverty, defined as a situation in which households spend more than 10% of their income on fuel.

Yes camp

The Scottish Government adopts the rather optimistic view that continuation of the integrated British system implies that that independence *per se* will have little impact on the cost of renewable energy, partly because of the view that the rest of the UK is a 'captive market.' Furthermore, since there will also be no contribution to the increased costs of nuclear power by Scottish consumers, affordability should, if anything, be improved relative to remaining within the UK.

No camp

No asserts that the financing of Scottish renewables entirely within Scotland will impose a huge burden on Scottish consumers since the price hikes would need to be substantial to compensate for the loss of the contribution of the 27 million households in the rest of the UK: the entire burden would have to be borne solely by the three million households in Scotland (assuming that funding occurred entirely through customers' bills, as at present). Indeed the scale of the changes may be politically infeasible, threatening the deployment of renewables in Scotland and the Scottish Government's ability to meet either its renewables or emissions targets longer-term.

Assessment

The truth lies somewhere between these two positions. If Scotland is independent the Government of the rest of the UK would almost certainly base decisions about its imports on a much more straightforwardly commercial basis. There would inevitably be pressure on affordability from reduced funding for renewables from the rest of the UK. However, there would undoubtedly be some legal challenge to the idea that the Government of the rest of the UK could stop funding renewables schemes in Scotland that were agreed prior to independence. If the requirement for internal funding of renewables only applies to new capacity from independence, the impact on Scottish consumers would be much reduced, at least initially. However, the commitments would imply increased electricity prices, even in the short- to medium terms, though it is possible that this increase could be less than if Scotland remained within the UK and had to fund its share of nuclear.

Economic development potential

Successive Scottish Governments have emphasised the economic development potential of low carbon technologies in general and renewables in particular. The concentration of renewable resources in Scotland, both onshore and offshore, renders their exploitation particularly attractive here as they offer the opportunity simultaneously to reduce emissions and stimulate economic activity. Few policy instruments offer this kind of 'double dividend': in general emissions move directly with economic activity. So renewables are one possible way of tackling the trade-off

between the environment and economic growth so as to achieve sustainable economic growth.

Yes camp

The Scottish Government's targets for renewable energy developments are often explicitly tied to the development impact that meeting the target may confer on the Scottish economy. The renewable energy roadmap, for instance, mentions that the Scottish Government's target of the equivalent of 100% of Scottish electricity consumption produced from renewable electricity in Scotland is: 'A target that is necessary to reindustrialise Scotland through 21st century technologies.'

No camp.

No is sceptical of the ability of an independent Scotland to fund the scale of investment that Scotland's renewable targets imply.

Assessment

The Scottish Government is probably unduly optimistic about the ease of development of Scottish renewables, especially offshore. However, estimates that we referred to earlier suggest that The UK Government's view is unduly pessimistic on the prospects for Scottish renewables. And with pressures on energy prices to rise because of domestic energy policies for both Scotland and the rest of the UK, the key to international competitiveness, which will influence the ability to export electricity and technologies (in the case of marine), will be how energy prices elsewhere develop.

Conclusion

It is fairly clear that: cooperation between Scottish and the rest of the UK Governments is likely to be beneficial to both sides for most, if not all, of their energy policy goals; affordability is going to be a major issue for both Governments; both yes and no camps are prone to exaggeration. However, our analysis does not amount to anything approaching a full cost benefit analysis of the likely impact of independence.

Further Information

The Future of the UK and Scotland programme, funded by the Economic and Social Research Council, brings the best of UK social science to the debate about Scotland's constitutional future and its implications for the rest of the UK.

<http://www.futureukandscotland.ac.uk/programme>

What Scotland Thinks provides impartial, up-to-date information on public attitudes to Scottish independence including the latest Scottish Social Attitudes survey findings.

<http://whatscotlandthinks.org/>

Scotland September 18 – data, evidence and facts in relation to the referendum.

<http://scotlandseptember18.com/about/>

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