

ECONOMIC POLICY OPTIONS FOR AN INDEPENDENT SCOTLAND

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TABLE OF CONTENTS

Summary	3
Section 1: The areas in which an independent Scotland could exercise economic powers.....	6
A. Monetary Policy.....	6
B. Fiscal Policy	8
C. Natural resource exploitation.....	12
D. Whisky.....	15
E. Utility Pricing.....	16
F. Competition policy	18
G. Procurement policy.....	20
H. Research and Development	22
I. Industrial policy and enterprise	24
J. Higher Education.....	26
K. Social Security	27
L. Financial sector regulation and stability.....	28
M. Employment Policy	29
N. Skills for Young People:	30
Section 2: The context which will determine how these powers are exercised	32
Socio-economic models.....	33
Constraints.....	34
Public expenditure resource constraints.	35
Uncertainties.....	38
Section 3: In Conclusion	41
References	42
Authors.....	43

SUMMARY

This paper has been produced as a joint exercise between Options for Scotland, and the Jimmy Reid Foundation. It is designed to take a radical look at the type of economic policy options which would be open to an independent Scottish government. It does not make any assumptions about what the political stance of a post-independence Scottish government would be: but the approach is consistent with the Jimmy Reid Foundation concept of the Common Weal.

There are many, many countries, with less resources than Scotland, who survive comfortably as independent nations. We therefore take the viability of an independent Scotland as a given. What we are going to be showing here is how the major economic levers in the UK are at present being operated in a way which is very sub-optimal for the social and economic well being of Scotland: and what positive steps Scotland could take to redress this situation using the powers open to it under independence. However, as the paper explains, it is not an attempt to set out an economic blueprint.

The largest part of the paper, Section 1, looks at various economic powers which an independent Scotland would be able to exercise. The primary purpose in each of these areas is to identify what has been going wrong to date, given the way that Scotland is managed as part of the UK: to identify the improvements which an independent Scotland would hope to make: and to suggest some of the approaches an independent Scotland might take to achieve these improvements.

The specific areas dealt with in Section 1 are as follows:

- A. Monetary Policy: the key decision is whether Scotland should move towards its own currency.
- B. Fiscal Policy: the paper identifies ten specific failings in the UK operation of fiscal policy.
- C. Natural Resources: how should Scotland achieve effective control of its own resources, so that a greater share of the benefits comes to Scotland.
- D. Whisky: similar issues arise as in natural resources.
- E. Utility Pricing: Scotland has the opportunity to correct the current flawed,

and unduly expensive, UK approach.

- F. Competition Policy: how to make Scottish firms less vulnerable to being taken over.
- G. Procurement Policy: more can be done to make the £11 billion programme of public procurement a driver of a knowledge economy.
- H. Research and Development: how to improve Scotland's weak record on business research and development, particularly using the strengths of its academic sector.
- I. Industrial Policy and Enterprise: there is much to be gained (i) from properly integrating those aspects of policy which are currently awkwardly split between reserved and devolved responsibilities, and (ii) from moving towards a more balanced economy.
- J. Higher Education: there needs to be a review of priorities and structure.
- K. Social Security: current UK policies could be liberalised.
- L. Financial Sector Regulation and Stability: there are advantages to an independent Scottish approach – but also difficult transitional issues.
- M. Employment Policy: there is much to be gained from reversing the current trend of regarding employees primarily as commodities.
- N. Skills for Young People: options for improving young people's opportunities in the labour market.

The second section of the paper explains why this does not amount to an economic blueprint for an independent Scotland. First of all, because the path of future economic strategy depends on a number of choices about the type of society and economy which Scotland hopes to foster: these choices should properly be taken by the Scottish people and government, and it is not for us to pre-empt this process. Secondly, because future economic policy will inevitably be bound by a number of constraints: some of these constraints will themselves be determined by decisions made in the process of achieving independence, and are therefore currently unknown. And finally, because a major factor influencing economic policy will be events in the wider world – particularly the way in which the currently unfolding crises in the world, European, and UK economies play out.

In the final section we draw some important conclusions both about the way in

which economic policy in Scotland should be developed: and about the path to independence itself. In particular:

- 1) Fundamental to all economic policy making by an independent Scotland would be basic decisions about what sort of society and economy we want to achieve.
- 2) Scotland has to be very careful that in negotiating its relations with bodies like the rest of the UK and the EU, it does not make concessions which will impose constraints which ultimately prove to be crippling. Any choices, for example, about forming a Sterling currency union with the rest of the UK would have to be viewed very carefully in this respect.
- 3) An independent Scotland is going to have to have the will and courage to deal with some of the other constraints it will face. In particular, it will have important choices to make about how it is to ensure that Scotland gets a fair share of the benefit from its natural and other resources.
- 4) Scotland will have to be pragmatic and opportunistic about how it responds to the uncertain course of world economic events. In particular, it will wish to avoid the risk of being damaged by any potential crisis in the rest of the UK, while being able to respond to possible opportunities, for example, for easing the transition to an independent currency.

SECTION 1: THE AREAS IN WHICH AN INDEPENDENT SCOTLAND COULD EXERCISE ECONOMIC POWERS

In this section we take a bottom-up approach, looking at individual areas in which an independent Scotland would exercise its economic powers, and what it might hope to achieve in each of these areas. In practice, of course, it will be limited by the kind of fundamental choices, constraints, and uncertainties which are discussed in section 2.

A. MONETARY POLICY

Monetary policy is primarily concerned with setting interest rates in a way which is consistent with achieving an acceptable blend of price stability, together with reasonable and sustainable economic growth. But since interest rates and exchange rates are so closely tied up together, exchange rate issues cannot be separated from consideration of monetary policy.

Viewed from the perspective of Scotland, (and indeed, from the perspective of most parts of the UK), the conduct of UK monetary policy since at least the Second World War has been profoundly unsatisfactory. As analysed in detail in J. Cuthbert, (2013), the UK's international competitiveness, measured by its real exchange rate, has been in a process of long term decline. This has been due to a number of complex factors: but mismanagement of monetary policy played an important contributory role. For example, mismanagement of the exchange rate has meant that the UK's real exchange rate has been subject to damaging short term fluctuations, on a scale greater than most other advanced economies. This has contributed to decline in the UK's productive industries, and the emergence of a chronic deficit in the UK's balance of payments in non-oil goods and services. This deficit has been funded first of all by the revenues from North Sea oil and gas: and latterly by borrowing, and the activities of an overblown financial services sector.

Essentially, the UK economy has become over dependent on the financial sector, (and has itself been likened to a large bank), with monetary policy managed predominantly in the interests of the finance dominated South East. Over reliance on monetary policy has left governments powerless to prevent increasing disparities between the different parts of the UK. This was more or less accepted by Eddie George, former Governor of the Bank of England, when he stated in an interview that job losses in the north were an acceptable price to

pay for curbing inflation in the south. He added, “*monetary policy can only target the economy as a whole, not particular regions or sectors, however uncomfortable that reality might be.*” (BBC News, 5th November, 1998).

The UK now has greater regional differentials than any other major European economy. For example, gross disposable income per head in inner London is more than half again the level in Scotland: Nottingham had an average income of £10,834 in 2011 compared to inner London-West with an average income of £32,823: (see M. Cuthbert, 2013, for more detail). The following table shows how the culture of excess associated with an overblown financial sector has also contributed to marked disparities in personal income.

Table 1: Average Weekly Earnings in £ by sector in April 2013

Average weekly earnings	Total pay (£)	Of which bonuses (£)
Across all sectors	484	46
Financial and business services	658	143
Manufacturing	560	29
Construction	550	33
Wholesale, retail, hotels, restaurants	317	26
Public sector	476	2

Source: ONS

Regional imbalances are directly related to UK wide monetary policy. For example, a study by Dow and Montagnoli, (2007), shows that, within a monetary union, monetary policy will have different effects in different areas if there are major differences in factors such as indebtedness. Areas with relatively high levels of personal housing debt will react quickly to changes in interest rates: areas with relatively low indebtedness will be more sluggish in their reaction but the dampening effect is longer lasting. Average outstanding debt due to housing in London in 2012 was £250,000: twice or more than that of all other UK areas with the exception of the East, South East and South West of England.

And it is not just that the mismanagement of the UK’s monetary, (and other economic) policies has led the UK to a position of marked imbalances: that position is itself likely to be unsustainable. Viewed as a large bank, “Bank UK” has

both assets and liabilities of over 700% of GDP, (larger than any other major economy) – and these are growing at a compound rate of around 8% per annum relative to GDP: (see J. Cuthbert, 2013, for more details.) Moreover, with public sector net debt at 76% of GDP and rising, the UK is unlikely to be able to withstand the next major economic shock – whether this originates externally, (e.g., from a messy resolution of the Euro crisis), or is home grown, (e.g., in the shape of the collapse of another major financial institution).

The basic choice for an independent Scotland as regards monetary policy would be whether it wanted to control its own monetary policy, (in which case it would need to have its own currency), or whether to opt for some arrangement like membership of a currency union, or operating a currency peg, both of which would involve ceding control over monetary policy. This is a difficult choice. Without its own currency, can Scotland escape from the drawbacks of having a monetary policy delivered primarily in the interests of the South East of England, (or indeed of Germany, if Scotland chose to join the euro)? On the other hand, it is sometimes objected that an economy of Scotland's size, with its own currency, would have an inherently unstable exchange rate. This is not necessarily so: in fact, countries like Norway, Denmark, and Switzerland have managed their currencies historically in a more stable fashion than the UK.

The key imponderable about Scotland having its own currency is the potential transitional costs of getting there. This, above all, is a question which depends on future, and therefore unknowable, events, as we discuss in section 2. What might look now like a daunting transition, could well look much easier, when viewed from the perspective of a major UK economic crisis. So the important thing is for Scotland to keep its options open.

B. FISCAL POLICY

Fiscal policy covers the whole area of how the government manages its taxation and spending: in order to achieve its objectives as regards public services, to steer the economy, to service its debt obligations, and to achieve social justice objectives of redistributing resources between different groups. Here we list a number of failings in UK fiscal policy.

- 1) One marked feature of UK fiscal policy over the past forty or so years has been the tendency to make public expenditure decisions without paying proper attention as to whether the tax revenues which supported that decision were sustainable or not. This was true in the 1980s, when the tax

revenues from oil and gas were used to fund public expenditure: effectively the UK government was using up an irreplaceable *capital* resource to fund *current* expenditure. But similar short sightedness was also demonstrated under the Blair/Brown premierships, where major increases in public expenditure were funded by tax revenues which ultimately derived from an unsustainable financial bubble.

- 2) Another aspect of the UK's fiscal short sightedness can be seen in its policy on the taxation of hydrocarbon reserves. In the 1980s and 1990s, the UK was generally perceived as having one of the most generous regimes in the world for the taxation of oil and gas exploitation. The UK's desperation for tax revenues was such that it was prepared to use a very generous tax regime to maximise rapid exploitation of resources – without paying due attention either to long term reserve retention, or to the possibility that a more conservative tax regime might actually increase the total of tax revenues in the long term. And this is a lesson that the UK government has clearly not yet learned, given George Osborne's recent boast that he was introducing the world's most generous tax policy as regards profits from gas fracking. Under the Chancellor's regime, shale gas producers will pay just 30 per cent tax on their profits, compared to the 62 per cent that the oil and gas industry has traditionally paid: (Independent 19th July 2013).
- 3) The right balance needs to be struck between giving adequate incentives for enterprise and individual effort, while on the other hand, achieving what society would regard as a fair distribution of the national product between different groups. The UK has currently very low marginal rates of tax for the highest earners: the effect of this policy has been to achieve the worst of both worlds – marked and increasing disparities in income distribution combined with sclerotic economic performance. On a per capita basis, UK income is 6.3%, less today than it was five years go. According to Ha-Joon Chang, (Guardian 26th July 2013), *"This performance is far worse than what Japan managed during its infamous "lost decade" of the 90s. At the end of that period, Japan had a per capita income 10% higher than at the start."*
- 4) The UK has clearly not got its policy on corporation tax right. As recent well-publicised examples illustrate, major multinationals can use shadow pricing and other devices to ensure they pay virtually no tax in the UK, while such opportunities are not available to small local firms. The effect is not just to damage the tax base, but it also places indigenous UK firms at a competitive disadvantage relative to multinationals, hence limiting the prospects for organic growth in the UK economy, and it can lead to businesses being moved

elsewhere.

- 5) The tax base in the UK has been damaged by the failure to put in place adequate incentives for small businesses to move out of the black economy into the conventional economy. This will have handicapped economic growth. For one thing, it is likely that many small businesses will have chosen to forego growth so as to remain below the tax radar: and another adverse effect is that tradesmen operating in the black economy are unlikely to be bringing on apprentices and employing journeymen. It would be quite possible to use the tax system more imaginatively to help remedy this situation. In France, for example, a reduced rate of VAT applies for works concerned with the improvement, conversion, and repair of a residential property (over 2 years old). The rate is 7% rather than the normal rate of 19.60%. The property can be either the main residence, or a second home. (Source: French-Property.com). An initiative like this could help both improvements in the housing stock and reduce the incentive for firms to be in the black economy.
- 6) A perverse aspect of UK fiscal policy has been the limited extent to which it has been willing to use within UK variations in tax rates to stimulate either particular regions or industries. At times, UK policy in this has been self contradictory: for example, Gordon Brown steadfastly maintained the importance of the UK being able to set its own rates within Europe on taxes like corporation tax: but at the same time he refused to countenance any within UK variations in corporation tax rates.
- 7) The UK has refused to use the scope it has within the EU rules on VAT to introduce lower rates which would encourage specific industries: for example, in France food and drink served in restaurants and bars is taxed at a lower VAT rate, as is repairs and maintenance. In Ireland, VAT was reduced to 9% in the tourism sector almost two years ago. A recent analysis from Dublin City University Business School found that around 1,000 new jobs had been created in the restaurant sector alone directly as a result of the VAT reduction. Other sectors such as catering services, hotels, cinemas, theatres and hairdressing have also benefited from the VAT reduction. It would, of course, be very sensible to make such changes for an independent Scotland: but would not make sense for the whole of GB, which does not need such a stimulus given its overheated South East.
- 8) Fiscal policy is one of the major tools available to a country in managing recessions and booms in the economy. At the start of the financial crisis in 2008 and the subsequent recession, the UK government was more interested

in stimulating consumer spending and trying to get it back to pre-recession levels than in positive use of fiscal policy to encourage capital investment and therefore the long term health of the economy. An OECD study, (OECD, 2009), showed that the tax measures introduced in many countries were specifically targeted to help manufacturing technology, energy efficiency and transport – and in some cases, small- and medium-sized businesses were given extra support as they generally have been hit hardest in the crisis. This contrasted with the unimaginative approach to fiscal policy adopted by the UK then, and now.

- 9) A specific case where UK decisions on benefits unjustly penalised Scotland occurred when Scotland was introducing its initiative on Free Personal Care for the elderly. The Scottish government decision to financially support personal care in care homes for the elderly out of its devolved budget resulted both in the Department of Works and Pensions removing the entitlement to attendance allowance and the care component of disability allowance, and in the Treasury not allowing the Scottish government to use the funds to help with the financing of the free personal care package. There was therefore a net loss to Scotland's finances as Attendance Allowance and Disability Allowance come from reserved UK budgets. If Scotland had been independent, it would of course have been able to switch the way it was using its funds without any such penalty.
- 10) Finally, the way the UK has operated certain specific taxes has had an adverse effect on Scotland. This is true, for example, of air passenger duty, (APD): the high levels in mainland UK mean that Scottish tourism is at a disadvantage relative to competitors like Ireland. (It is relevant to note that when responsibility for setting APD was devolved to Northern Ireland in January 2013, Northern Ireland immediately effectively abolished it – reducing the rate on all but the shortest band to zero). And the high levels of fuel duty impact adversely on the remoter parts of Scotland – an effect only slightly mitigated by the 5p reduction in fuel duty under the Rural Fuel Duty Relief scheme, which only applies to the Scottish islands, (and the Isles of Scilly).

There are thus many ways in which the operation of fiscal policy by UK governments has been unsatisfactory – both for the UK as a whole, and specifically for Scotland. In each of these cases, an independent Scotland would be able to make its own choices and do something different. What is perfectly clear is that the choices a Scottish government would make, with Scotland's interests at heart, would be different from those made by any UK government.

C. NATURAL RESOURCE EXPLOITATION

Given Scotland's geography, a very important set of choices to be made by a Scottish government will be those surrounding the exploitation of Scotland's natural resources – of oil and gas, fisheries, renewable energy sources, the sea bed, harbours and ports, and land. What is striking in each case is how little control Scotland has over any of these resources, and how many vital decisions have been taken which are not in Scotland's interests.

Here are some examples.

Fisheries: Essentially, Scotland's fisheries were sacrificed as a bargaining counter in the UK's accession negotiations to the EU. Scotland lives with the consequences of this to this day: and the effects are compounded as we are represented in critical EU fisheries negotiations, not by any Scottish Minister, but by a junior Westminster Minister.

North Sea oil and gas: it is not just that these resources are being exploited in a short term profligate manner, with little regard to long term conservation of the resource, or using the tax revenues to provide a lasting legacy. In addition, much of the related employment takes place outside Scotland, and much of the profit goes out of Scotland without having any impact on the Scottish economy. According to UK Oil and Gas, only around 45% of UK continental shelf related jobs are located in Scotland, (and 21% in London and the South East), even though Scotland accounts for about 80% of UK hydrocarbon production. A provisional estimate produced by Scottish government statisticians in 2010 indicated that there was an outflow of private capital from Scotland in 2008-09 of £16.7 billion, (largely expatriation of profits from the North Sea): (minutes of Scottish Economic Consultants Group Meeting, 18th October 2010.)

Land: Scotland is almost unique in the extent to which its land is concentrated among a few landowners: and in the extent to which there is no control on non-residents buying up Scottish land. The Independent, (1st August 2013), describes Scotland as a feudal country where 432 families own half of non-public land, and as having the most concentrated pattern of private ownership in the developed world. Among the adverse effects of the secretive offshore ownership of land is that it gives various tax advantages. In an investigation undertaken in 2003, Andy Wightman and Torcuil Crichton analysed 500 estates and estimated that the annual loss of tax

revenue was around £72 million due to offshore ownership, noting that: *“The true figure would be much more if it were possible to survey all of Scotland.”* (Sunday Herald, October 2003). The situation in Scotland, which is one of the few countries in Europe which allows wealthy foreigners to buy up unlimited amounts of land, contrasts, for example, with Norway, where land can only be held by residents, and changes in land use are subject to approval by the local community: or indeed with Denmark where there are strict controls on who can own land.

Renewable energy: linked to the question of land ownership is the way in which onshore wind energy is currently being exploited: this is leading to what one commentator has described as *“the biggest transfer of money from the poor to the rich that we’ve ever seen in our history”*. According to one estimate, Scotland’s wealthiest private landowners are on course to earn around £1 billion over the next eight years in rental fees from wind farm companies, ultimately subsidised by the consumer: (Stevenson, 2013). In effect, landowners are benefiting from a huge unearned economic rent, while at the same time electricity customers are paying for this in terms of higher energy costs.

Sea bed: The sea bed is administered by the Crown Estate Commissioners, a UK body. It is important to be clear that the crown estates are held “in right of the crown”, and are quite distinct from any property, like the Sandringham estates, owned personally by the Queen. Property owned “in right of the crown” is effectively public property – that is, owned by the people. And in fact, as the 1998 Scotland Act makes clear, the ownership of crown estates in Scotland is a devolved matter: that is, in essence, the ownership of the crown estates in Scotland rests with the people of Scotland.

A report by the Crown Estate Review Working Group, (CERWG,2006), recommended that *“In the changed circumstances of devolution, Scotland’s seabed and foreshore could be managed as a national marine estate like Scotland’s national forest estate, to help deliver Scottish Executive policies that support the future well being of Scotland’s coastal communities and benefit the people of Scotland more generally.”* The Cabinet Secretary for Rural Affairs and the Environment, Richard Lochhead, announced that the Scottish Government was minded to reform the present situation and had begun discussions with the Secretary of State for Scotland, Michael Moore MP, who was said not to be hostile to such intentions. However, no effective reform has taken place.

One reason why the seabed is important is because of the licence fees that will arise if offshore wind and tidal energy fulfil their potential. Under present arrangements, the bulk of such revenue would feed into the profits of the Crown Estate, which are split 85% to the Exchequer, 15% to the Sovereign. (This latter arrangement was introduced recently by George Osborne in the Sovereign Grant Bill, to avoid annual embarrassment over the Queen's Civil List payment, and also, it is said, in an attempt to bind the hands of any future independent Scotland's administration.) The important thing is that the profits from Scotland's seabed are not at present under the control of Scotland, and are of minimal benefit to Scotland.

A fundamental priority of an independent Scotland will be to change the terms in which the above resources are exploited, so that more of the benefit stays in Scotland, and so that decisions about sustainability and conservation of resources are made taking proper account of Scotland's interests. The important point is that an independent Scotland would have the power to ensure that such changes actually happened. That is not to say that an independent Scotland is likely to use its ultimate power, that of nationalisation. It is much more likely that there will be a series of negotiations with the existing owners/exploiters of our natural resources, coupled with appropriate incentives – e.g., through the use of taxation, or of conditions built into licensing agreements. We give some examples here.

Fisheries: An independent Scotland would be in control of its own fisheries. If Scotland chose to remain in the EU, it would represent itself to achieve its own objectives, rather than being represented as part of a wider bloc which had different interests. In addition to strengthening its own fishing fleet, it would be in Scotland's interests to develop its fish processing industry. Currently, large amounts of stocks landed here leave immediately for processing elsewhere. Developing the industry in Scotland would be an important pillar of regional development policy within Scotland.

Oil and gas: While an overall increase in taxation levels is possible, (for example, the marginal rate of tax on oil reserves in Norway is 78% compared with 62% in the UK), in practical terms what may be more likely is a restructuring of the incentives in the tax system, plus conditions built into future licensing rounds, to make sure that more of the revenues from the North Sea are actually spent or invested in Scotland. The other side of this coin would be to take steps to ensure that the Scottish economy was as receptive a partner as possible to the oil and gas industry: we already have some notable successes, particularly in supplying goods and services to the rigs. We need more.

Land: A land value tax could bring much more land into productive use: perhaps associated with legislative changes to ensure that land in Scotland could only be owned by identifiable individuals, resident in Scotland. And perhaps an independent Scotland would pursue more vigorously than a devolved government the breaking up of large estates and enshrining tenant's right to buy.

Renewable energy: Given the subsidy commitments to renewable energy, and the question of whether these will be affordable in the long term, an independent Scottish government might well wish to commission a thorough going review of the viability of the present subsidy schemes.

Seabed and Crown Estate: In relation to the Crown Estate generally, and the seabed in particular, an independent Scottish government would immediately gain control of all profits. It would be open to Scotland to put an immediate end to the iniquitous provisions of the Sovereign Grant Bill of 2011, under which 15% of the profits of the Crown Estate are hypothecated to the UK monarch. In addition, control of the seabed would mean that the Scottish government could use the licensing arrangements for renewable energy developments to ensure that the Scottish economy and businesses benefited as much as possible from the associated employment, from the sourcing of goods and services, and from the associated R&D.

D. WHISKY

Very similar issues as those relating to natural resources also occur with what should be one of the crown jewels of the Scottish economy – namely whisky.

A series of uncontrolled takeovers has meant that most of the whisky industry is now foreign controlled, (some estimates put outside control at 83% of the industry) – with adverse effects both on the industry's current economic impact on Scotland, and on the long term future of the industry itself.

An analysis of the economic impact of the whisky industry carried out by Biggar Economics, (Biggar Economics, 2012), gave the following estimates:

- In 2011, the industry had an estimated turnover of £5.048 billion: of this, £1.22 billion was accounted for by goods and services sourced in Scotland, and £0.526 billion by employee costs.
- Operating profit and return on capital were £3.013 billion.

So the direct economic benefit to Scotland, (that is, employment costs plus

supplies sourced from Scotland), represented just 35% of turnover. And because much of the whisky industry is owned and controlled from outwith Scotland, most of the £3.013 billion profit and return on capital will have been lost to Scotland, (and indeed to the UK). In a BBC programme based on the Biggar review, Professor John Kay is quoted as saying: *“I think the benefits to Scotland from the whisky industry are really quite disappointing. The largest producers are not based in Scotland. Their profits go mostly to people who are not resident in Scotland. They don't pay much tax in Scotland, and we don't think they pay much tax in the UK.”*

The long term situation is even worse than implied by this simple snapshot. Figures quoted by industry insider Donnie Blair, in the Sunday Herald of 17 January 2010, showed that Scotch whisky volumes had been growing at what he described as an “awesomely pedestrian” rate of 0.082% per annum since 1978, while the equivalent growth rate for vodka over the last 20 years was 3.5%. Some industry insiders take the view that this has been the result of a deliberate policy on the part of the drinks industry, as without the need for long periods locked up in bond, profit margins are higher for spirits like vodka.

So under present arrangements, Scotland receives a relatively meagre benefit compared to the size of the whisky industry turnover, and the long term future of the industry is not as secure as it should be. But this is a situation an independent Scotland could do much to resolve. Just as in the case of natural resources, it could engage in a meaningful negotiation with the present owners of the industry – backed up by real powers, for example, on taxation, to ensure that changes did take place. One specific proposal which has been made is that a Scottish government could change the system under which whisky distilleries are licensed. Currently, licences are perpetual: this could easily be altered to time limited licences, with renewal conditional on a variety of performance targets.

E. UTILITY PRICING

An area for which an independent Scotland would be responsible, but which is now largely reserved to the UK government, is utility regulation. Water is the exception – regulation of the water industry in Scotland is carried out by the Water Industry Commission for Scotland under the direction of Scottish Ministers: on the other hand the regulation of gas, electricity, rail, and airports, are all reserved to Westminster.

One of the responsibilities of a utility regulator is to set limits on the charges

which utility companies can make. An important element of this regulatory pricing calculation involves working out how much the utility operator should be allowed to charge to cover the costs of capital investment. This is an area where the approach adopted by UK utility regulators is flawed, and where there are significant opportunities for an independent Scottish government to do better.

The reasons for the flaws in the capital pricing element in the model used by UK, (including Scottish), regulators are complex: but they relate basically to the unrealistic way in which the effects of inflation are allowed for: (for a detailed analysis see J. Cuthbert, 2012). The effects, however, are plain for all to see, in the shape of excess profits earned by utility operators. To give an example, the academics Lobina and Hall found, in respect of the privatised water companies in England and Wales, that

“Profit margins in the UK are typically three or even four times as great as the margins of water companies, private and public, in France, Spain, Sweden or Hungary. The profit margins of the greatest water multinationals – Suez-Lyonnaise and Vivendi – worldwide, also show a much lower return than enjoyed by the UK companies.” (Lobina and Hall, 2001).

The counterpart of these excess profits is, of course, unduly high prices for utility customers: and also, in a rather more subtle effect, the probable distortion of the investment priorities of the utility operators.

An independent Scottish government would have the opportunity to introduce a more rational utility pricing model. This would have important price advantages, which would both benefit Scottish domestic customers, and would help to give Scottish industry a competitive edge.

There would, of course, be a reduction in unearned windfall profits currently accruing to privatised utility operators – but this can hardly be called a drawback. In fact, this would have the important advantage of making any privatised utility companies operating in Scotland much less tempting targets for takeover.

It might be objected that, since water regulation is devolved to Scotland, why has the Scottish government not already introduced appropriate changes in relation to the publicly owned water industry in Scotland – where the same flawed pricing model is employed. Only the Scottish government can know the answer to this. But we may presume that part of the reason is that, because of the excess charges flowing from the current pricing model, the Scottish government has been able to reduce the amount of borrowing it needs to make to fund capital

investment in the Scottish water industry: and has been able to transfer the resulting saving to other priorities. In effect, the present situation in Scotland is that water charges are being used as a concealed form of taxation. This situation may make sense just now, given the very limited other forms of taxation available to any Scottish government under the current devolution settlement. An independent Scottish government would no longer be operating under such artificial constraints, and would be well able to secure the advantages of introducing a more appropriate pricing model for water and the other regulated utilities.

And finally, while this section has been concerned with the issue of utility pricing, an independent Scottish government could also look at broader issues: for example, they could consider a model where replacement provision of utility infrastructure was in public ownership, perhaps financed by publicly raised bonds.

F. COMPETITION POLICY

Competition policy is concerned with prohibiting agreements or practices that restrict free trade: banning abusive behaviour by dominant firms in a market: and supervising mergers or acquisitions of large corporations. Within the EU, EU competition law lays down detailed provisions to which member states must adhere: so if an independent Scotland were in the EU, its freedom of action with respect to competition policy would be relatively limited.

Nevertheless, within the existing EU, there are significant variations from country to country in the extent to which barriers exist, or can be put in place, to restrict company takeovers. The UK has had a policy of having minimal barriers to takeovers: this is consistent with the UK's dependence on the financial services industry, and the large fees accruing to that industry from unrestricted takeover activity. Scotland has, however, suffered badly from this. This has occurred both at the level of major firms, (to give just a very few examples, United Distillers, Scottish Power, Scottish and Newcastle), whose takeovers have resulted in loss of control, of high quality functions, and of profits, from Scotland. But it has also occurred very damagingly at the other end of the size spectrum, where many high tech start-up companies with good prospects have been taken over, and effectively lost to the Scottish economy, after a few years of operation.

An example of this is Scotland's experience with the innovative idea of one-day disposable contact lenses. Ron Hamilton, a high flying executive in a company in

the contact lens business, dreamt up the idea of one-day disposable contact lenses. He secured a patent on the product and set up his company, Award, in 1993 in Livingston with a £300,000 grant from the Scottish government and £100,000 of his own capital. But in 1996, faced with a good offer from Bausch and Lomb, he sold the business, retaining the patent rights, which he then sold to them in 1999. Thereafter decision making and research and development moved to Rochester, New York: the Scottish operation, of at times well over 1,000 employees, became just one disposable cog in the 14,000 employee strong company. The Scottish management then had to fight its corner to retain production and/or get new investment. It finally lost out to a rival site in Ireland, with the Bausch and Lomb plant in Scotland closing, and production shifting to the company's plant in Ireland where it benefited from considerable business financial support and lower business rates. This is an all too common story.

So, how do other countries solve the problem?

- Some countries protect vital sectors from foreign takeovers: this is true even for members of the EU, and also for the US.
- The financial system can play an important role. For example, in the German economic model, based on what is known as Rhenish capitalism, banks are much more supportive of businesses, providing long term finance so that businesses are much less dependent on the equity market.
- Corporate governance structures also influence the ease with which companies can be taken over. For example, in Germany the structure of corporate governance laid down for stock corporations under German company law places a de facto constraint on takeovers. Under German company law, there is a two tier board system, with each company having a management board, and a supervisory board. The supervisory board contains both shareholder representatives, and employee representatives. Employee representatives constitute between 33% to 50% of the supervisory board, depending on a variety of factors like the number of German located employees of the company, and the industry sector in which it operates.

An important area for an independent Scottish government to consider would be how it could inhibit takeovers of Scottish firms, without infringing EU competitiveness and state aid laws: without damaging Scotland's attractiveness

to foreign companies as a destination for foreign direct investment: and without featherbedding Scottish companies so that their relative productivity gets out of line with international competitors. Any or all of the above could be considered. A Scottish government could, for example, consider introducing German style corporate governance as an option for Scottish firms: perhaps incentivised by giving tax concessions to firms who built in these sorts of employee rights. Or it might, as part of the conditions of access to funding from an expanded Scottish Investment Bank, require that the Scottish government acquire a “golden share” in assisted start up companies, which would give the Scottish government a say in future takeover decisions.

G. PROCUREMENT POLICY

The Scottish government and other agencies responsible for devolved services in Scotland spend approaching £11 billion per annum on procurement – the purchase of goods and services: and after independence the Scottish government would also be responsible for procurement in those areas which are currently reserved. In quantitative terms alone, therefore, government procurement has a huge impact on the economy. But the potential impact of procurement is much larger than just looking at amounts spent. Used pro-actively, government procurement can also be a major influence in driving technological progress, and in structuring economic growth. The classic example of this is the way the US has used its massive procurement budget to shape the world as we know it today: the internet, supercomputing, and container shipping are just three transforming technologies which grew out of US government procurement.

Unfortunately, neither UK governments, nor, (it must be said), devolved Scottish governments have used public procurement in a way which maximises its potential benefits to the economy. In fact, in many ways the opposite has been the case. As regards the procurement of large capital projects, the desire of successive UK governments to flatter their budgets by getting capital expenditure off the government’s books led them into the disastrous experiment of PFI. This has not merely proved costly and inflexible: but the fixed costs of PFI led to very large projects, which have meant that this market has tended to be restricted to a small number of major companies – with local firms largely squeezed out.

In the procurement of goods and services, chronic budgetary problems, and the perceived rigidities of the EU Procurement Directive, have led both UK and Scottish governments to place an over-emphasis on reducing short term cost as

the main factor in making procurement decisions. This has meant a concentration on the use of centralised purchasing arrangements, and, again, on contracts which are often too big for local firms to compete for: (see Cuthbert and Cuthbert, 2012 for a detailed analysis of the position in Scotland in 2012). Centralised purchasing arrangements also have the effect of breaking the direct contact between the public sector end user and the supplier: this makes it more difficult for innovative solutions to be developed for user needs. So the considerable amount of effort put into developing centralised purchasing arrangements can actually have adverse side effects.

Overall, what is important is to move away from seeing projects as individual items where short term considerations such as minimum price drive procurement, and to move towards seeing procurement as also being a strategic tool to assist long term economic strategy.

For a relatively small country like Scotland, it is a matter of great importance to ensure that contracts issued by government are, wherever possible, suitable for Scottish firms to compete for: and given that by far the vast majority of Scottish firms are small, this means that contracts must be suitable for such firms. It is clear from experience elsewhere in Europe that it is quite possible, within the framework of the EU Procurement Directive, to do much more to ensure that smaller and local firms benefit from government procurement spend: and also to use government procurement pro-actively to drive technological development. For example:

- It is a legal requirement in a number of European countries that government contracts must be broken down into lots, for which smaller firms can compete. Size of contract was identified in an EU study as one of the key obstacles to small firms entering the government procurement market, (EU 2010).
- In a number of countries, specific steps are taken to ensure that local food and produce are sourced for use in public undertakings such as schools, hospitals, prisons, etc. This includes the US, Canada, and Ireland: both Eire and Northern Ireland.
- In a number of countries, initiatives have been established to develop public purchase of innovation: that is, where public bodies work with potential suppliers to identify innovative products which will improve the efficiency of public services, and then fund the research to develop the required prototypes, (using, for example, an approach known as Pre-Competitive Procurement, which is entirely consistent with the EU

Directive). At its best, this type of approach can not merely improve the delivery of public services: but it can also create new firms and industries selling the new products into wider markets. An independent Scottish government could develop this approach, working with small business and start-ups .

H. RESEARCH AND DEVELOPMENT

Three noteworthy features of the Scottish economy are:

- How highly rated some parts of its higher education sector are internationally. Scotland's academics produce one per cent of all research publications in the world - ranking Scotland 3rd in the world for the number of research publications published per head of population: (Scottish Development International).
- The very low level of business research and development in Scotland. According to Scottish government and OECD figures, business research and development in Scotland was 0.5% of GDP, averaged over the over the ten years 2001 to 2010 compared with UK 1.2%, USA 3.1%, Sweden 2.7%.
- The low connectivity between Scotland's higher education institutions and Scottish based businesses. At present, many of the industrial links of Scottish universities are with businesses outside Scotland. In 2010, a study on SMEs showed that many businesses, particularly small and medium sized businesses, may not be aware of either what expertise exists within the academic base that could help them, or where to access this expertise: (EKOS, 2010). Further, although SMEs in Scotland account for more than half of private sector employment, they have relatively low graduate recruitment. Another indicator of the relatively weak connections between the academic base and industry within Scotland is that in total only 38.5% of first degree male graduates from Scottish HEIs find graduate employment in Scotland.

An independent Scottish government would clearly want to take steps to utilise Scotland's strengths on the first of these points, and improve the situation in the latter two. There are a number of ways it could achieve this.

Tax incentives: It could put in place specific tax incentives for business

research and development. Countries where this has been done include Canada, France, Ireland, and Italy. As the experience in Ireland indicates, such incentives can also attract innovative industries to relocate from elsewhere, (including in the past, from Scotland to Ireland.)

Natural resource licensing: An independent Scottish government could make undertaking R&D in Scotland a requirement for future rounds of natural resource licensing. (That is, it could be made a condition of obtaining a licence to exploit a hydrocarbon or renewable energy field that a specified percentage of the profits or revenues should be invested in R&D carried out in Scotland.)

Public procurement: Changes to public procurement, some of which have been discussed above, would help to increase business R&D in Scotland, as follows:

- There would be a direct effect if the Scottish government was using arrangements for public procurement of innovation in order to commission R&D. And this requirement should extend to Scottish Water, whose research programme to support its capital investment is at present of little value in fostering innovation in Scotland.
- There would be an indirect effect if, instead of giving so many procurement contracts to large multinationals, (who are likely to carry out any associated R&D elsewhere), the Scottish government was letting smaller contracts, and so dealing to a greater extent with local Scottish companies as primary contractors. This would mean a greater chance that the R&D required by these companies would take place in Scotland.

Effect of improved competition policy: In the discussion of competition policy above, it was suggested that it would be important for a Scottish government to develop means of making it less likely that small, high tech companies were taken over as soon as they started to show signs of success. If the Scottish government succeeded in doing this, this would in due course change Scotland's industrial mix with more of these companies growing on in Scotland: this would in itself improve Scotland's R&D

position.

Industry / academic interface: Since 2005, Scotland has been working on collaborative projects between academia and Scottish businesses through the Interface initiative. An economic impact study on the scheme's performance between 2005 and 2013 showed that the scheme was having a positive impact on small business performance, (Biggar Economics, 2013). However, comments made in the survey suggest that steps should be taken to improve academic time scales and the need to finish projects.

Collaborative research centres: A Scottish government could consider introducing a scheme along the lines of the Australian collaborative research centre approach. There, consortia, typically consisting of private firms and academic research institutions, bid competitively for funds to undertake collaborative research projects. This has proved a successful technique for bringing academic research expenditure to bear on industrial problems: and it has proved particularly successful in more traditional industries, where there has not been a strong R&D culture.

I. INDUSTRIAL POLICY AND ENTERPRISE

(i) Under the current devolution settlement, responsibility for different aspects of industrial and enterprise policy are split between Westminster and Holyrood. Functions like skills training and some aspects of regional development and regional selective assistance, are devolved: while other functions, like employment policy, trade policy, technology strategy, energy, and the operations of UK trade and industry, are reserved. (UK Trade and Industry is responsible for promoting UK business abroad, and attracting potential foreign investors to the UK).

This split between reserved and devolved functions has not worked well. There are cases where the exercise of reserved functions by Whitehall has clearly not involved taking a whole UK perspective. A classic example was the production of the Tourism strategy published by the Department of Culture, Media and Sport in 2000: in doing this, DCMS were meant to be exercising a reserved function. The following quotations from the foreword by the then Prime Minister Tony Blair to the DCMS strategy "Tomorrow's Tourism" (DCMS, 2000) illustrate confusion between whether DCMS is operating in a reserved or devolved manner:

"But the challenge facing us now is to create a competitive, world-class tourism industry in Britain which matches both the quality and the best of British business generally and the scale of

tourism in Britain in particular."

"I believe that the Government's new strategy for tourism - a strategy for England, but which has clear implications for Scotland, Wales and Northern Ireland - will help towards this goal."

The implicit assumption is that a strategy developed for England, after detailed consultation in England, should fit the characteristics of tourism in Scotland. This confusion was then carried over into the monitoring and development arrangements.

The converse of this is that Scottish agencies have on occasion felt that they should spend their own resources to compensate for the relatively poor service they were getting from their Whitehall counterparts in reserved areas. This has been particularly the case in overseas promotion.

The present situation is both wasteful and inefficient. Post independence, a Scottish government would lose the potential economies of scale implicit in being able to access the services of a body like UK Trade and Industry: but it would, on the other hand, be responsible for all aspects of its industrial strategy, and would be able to implement a properly integrated strategy. Given the experience of small countries like Ireland, which has been outstandingly successful in promoting its individual attractions, and encouraging foreign investment, the advantages of the integrated approach post independence are likely to outweigh any disadvantages.

Similar considerations apply to the Research Councils, which are another reserved function. Under the dual support system, the UK research councils provide grants for specific projects and programmes, while the Scottish Funding Council provides block grant funding for universities' research. As noted above, Scottish academic links with industry in Scotland are relatively weak. So, the loss of economies of scale post independence could well be more than compensated for by the ability to have a research agenda more specifically tailored to Scotland's priorities.

(ii) The de-industrialisation of the British economy is a serious problem, (see, for example, Kitson and Michie, 1996), and the same is true for Scotland. The economy has not only become heavily service based, but has experienced too much bias towards financial services. This bias has had a number of adverse effects: for example, it has involved putting too many of our eggs in one not very secure basket, and it has also been a major driving force in encouraging mergers and acquisitions.

A number of the options already outlined would help to rebalance the economy, and particularly to improve manufacturing and construction: for example, the suggestions on research and development, competition policy and government procurement are all of general relevance. And a specific industry like tourism could be helped by the kind of targeted reduction in VAT suggested.

In addition, there are a number of things a Scottish government might choose to do to actively influence industrial structure. Agriculture and food processing is one example. What Ireland has done shows how government intervention and public pressure can change the behaviour of supermarkets, to increase the proportion of Irish produced and processed food sold in supermarkets in Ireland, hence providing a domestic basis for a food processing industry which can then drive exports and reduce imports. Many supermarkets are focusing on their relationships with Irish producers and making that a selling point to shop at their store: indeed, Irish television (RTE) recently claimed that around 50% of the own-brand products sold by Aldi and Lidl stores in Ireland were now sourced in Ireland. And according to the same source, a major supermarket like Tesco works with 400 local suppliers in Ireland: whereas, according to a Tesco submission to a Scottish Parliament Committee, Tesco uses 155 Scottish suppliers, (Tesco, 2013).

J. HIGHER EDUCATION

A number of the suggestions we have made above have implications for Scotland's higher education sector, and we will not repeat these here. Overall, the higher education sector is expected to fulfil a whole range of disparate functions, all of which are vital for the economy: it is expected to teach, both in breadth, approaching 50% of young people, and in depth, up to the very frontiers of knowledge. It is also expected to do research, both advanced blue skies research, and more applied near market research. It is expected to commercialise its research, either selling patents or spinning out companies: and it is expected to collaborate with existing businesses.

All of these expectations have been heaped upon the sector in an unplanned and incremental fashion. There is a strong case for an independent Scottish government carrying out a thorough review, to see whether the priorities are right for Scotland's needs, and also to see whether the existing structure of institutions, going back in part to accidents of medieval times, is the appropriate one to best deliver what is expected today. In particular, Scottish higher

education institutions and businesses should be playing a leading role in all aspects of the research funding process, from choice of field to be researched, through to the particular problem to be investigated.

K. SOCIAL SECURITY

Social security policy, (at least in relation to benefits for those of working age), has a very important bearing on any government's economic strategy. In particular, it is important that the structure of benefits does not unduly inhibit those who are out of work, for whatever reason, from returning to work – assuming that they have the abilities, and that there are jobs available. Equally, the structure of benefits should not force those such as carers for young children into the workplace.

The particular approach adopted by the coalition government at Westminster has involved a number of components, but at root has been based on stigmatising those out of work, making it harder for them to obtain benefits, and in some respects, cutting benefit entitlement. (Part of the problem is that the UK government has to devise policies which will apply equally to the circumstances of the overheated South East, and deprived areas such as the Welsh valleys: and they have focused too much on the South East.) It is unlikely that an independent Scottish government would want to maintain such a socially divisive approach.

Fortunately, it is quite possible that a more liberal approach could actually be more effective in easing transition into the labour market.

- Scotland could stop the process whereby an unemployed person taking up a job cannot resume benefit entitlement immediately if the job turns out to be unsuccessful. Such actions to ease return to work could well result in more people eventually making a successful transition into permanent employment – and might actually cut the long term welfare bill.
- Temporary assistance with transport costs for young people seeking, or in, employment could be another step which would ease transition into the labour market.

L. FINANCIAL SECTOR REGULATION AND STABILITY

This area covers not just regulation of the financial sector, but also questions like how the deposits of savers in banks are going to be protected in the case of the failure of an institution, and who is going to provide the essential function of lender of last resort to the banking sector. The choices to be made here are intimately bound up with decisions about whether Scotland should have its own currency and, just as with the case of currency, these would be some of the most difficult choices for a Scotland moving towards independence.

The Fiscal Commission Working Group set up by the Scottish government, in its report on a macroeconomic framework for an independent Scotland, (Fiscal Commission, 2013), favoured a joint approach with the rest of the UK towards questions of financial sector control and stability. This stance was almost inevitable, given the Working Group's preference for Scotland forming part of a currency union with the rest of the UK. As events in the eurozone have demonstrated, it is not enough when designing a currency union to put in place limitations on the size of public sector debt and deficit in each participating country. Because the liabilities of the financial sector will, in a crisis, suddenly become public sector liabilities, it is essential in a currency union to have very close co-ordination of the arrangements for financial sector stability.

However, the Working Group's approach has major drawbacks:

- a) Agreeing the appropriate terms for such joint supervision would be dependent on agreement with the rest of the UK. The Working Group argued that it would be in the interests of both parties to the negotiation to achieve agreement on a workable system for financial stability. But it is not clear if the rest of the UK would agree to such a system at all: if they did, whether the conditions they would seek would be acceptable to Scotland: and whether such conditions would be consistent with any meaningful form of Scottish independence.
- b) It is not, in any event, clear that a financial stability and supervision model which would suit the rest of the UK would be able to escape the dominance of the financial sector, and achieve the improvements which a Scottish government would require.
- c) And any joint system with the rest of the UK, which would imply some shared approach towards the provision of lender of last resort facilities, is unlikely to be compatible with the option of Scotland

eventually having its own currency.

An independent Scotland responsible for its own system of financial sector regulation would ensure that the financial sector avoids the cultures of greed and excessive risk taking which marked the UK's financial system. If Scotland had been responsible for regulating its own financial sector, then HBOS and RBS would not have found themselves in anything like their current plight. It is just not conceivable, for example, that an independent Scotland would have let RBS build up the potential trillion pound exposure to the derivatives market which it was reported to have before the crash.

It would also be easier to avoid the culture of excessive risk if, as we suggested earlier, Scotland was able to provide effective safeguards against strategic Scottish companies being taken over. It is clear that one of the primary drivers of the reckless culture in the UK financial sector pre 2008 was an eat or be eaten environment, in which companies had to take risks in order to grow, or they faced the inevitable prospect of themselves being swallowed up.

There are, however, difficult transitional issues about moving to a separate Scottish system for financial regulation. Unless such a system has in place arrangements for deposit protection, and for provision of lender of last resort facilities, which are immediately credible, then the viability of the financial sector is likely to be compromised: (for example, financial institutions which require to borrow would incur an interest rate penalty). Just as is the case for a separate Scottish currency, future events are likely to dictate when and how easily such transitional problems can be tackled. Much will depend, for example, on the size and nature of the financial system which emerges from the next UK financial crisis. Much would also depend on how quickly and firmly an independent Scotland was seen to have established a grasp on the potential revenues from sources like natural resources and whisky.

M. EMPLOYMENT POLICY

One of the features of UK employment policy has been what might be called the progressive commodification of the employee. Far from being regarded as, in some sense, partners with a stake in the firms which employ them, employees have increasingly come to be treated as if they were just anonymous economic units, to be hired on the cheapest terms, and under the most basic conditions. Indicative of this trend have been the rise in zero hour contracts: the rise in employment at (or below) the minimum wage: the way in which employee hours

are now often staggered, leading to long working days which pay little regard to employee quality of life: and the progressive diminution in the power and status of trade unions in the private sector.

This trend has had a number of adverse side effects. Most obviously, an increasingly anonymous and alienated workforce is unlikely to go the extra mile in terms of commitment, or to feed in ideas for improving processes: this is likely to have an adverse effect on productivity and quality of service. A contributory factor, for example, to many of the recent scandals surrounding poor care standards in the NHS in England, is likely to be the disaffection of an increasingly alienated staff. This contrasts with the position in Nordic countries, where innovative ideas from employees at all levels are encouraged, and are widely credited with playing an important role in boosting industry performance.

Reducing the extent to which workers are regarded, and regard themselves, as mere commodities is therefore likely to have benefits. There are a number of options which could be encouraged to help achieve this.

- As discussed earlier: there is the possibility of having an option for German style corporate governance which would involve workers' representation on the supervisory boards of companies.
- Another possibility would be to introduce formal workers' councils, again perhaps on German lines. Any business in Germany with five or more employees (excluding management and senior staff members), has to have a Works Council if the employees want this. The Works Council has a right to be consulted on a variety of issues, including working conditions, and on matters like company restructuring, including takeovers.
- Another possibility is that some firms could be constituted as partnerships, (of which John Lewis is a successful example).

N. SKILLS FOR YOUNG PEOPLE:

The process we described in the previous section, under which employees are increasingly seen as mere commodities with a diminished long term stake in their employing organisation, has had particularly adverse effects on young people – especially those with poor or low qualifications. Young people with low

qualification levels now find it very difficult to get into the employment market. Of young people unemployed in Scotland in 2011-12, 24% had low or no qualifications, and 29% had been unemployed for more than a year: (Scottish Government, 2012).

The problem of youth unemployment is widespread in many advanced economies – and indeed in several places is very much worse than in Scotland. The problem has been aggravated by the current economic downturn. In 2008, before the financial and economic downturn, youth unemployment in Scotland was 13.5%, according to the Labour Force Survey: the latest figures for 2012-13 show an increase to 20.5%. And these statistics indicate that the solution to the problem is not just to make sure that young people have better skills: it will be necessary to attack the problem from both sides, both improving skills, and also improving job opportunities.

Scottish governments have already taken a number of steps. For example, they have increased the number of apprenticeships, made a guarantee of a job, education or training for young people leaving school, and moved more funds into helping alleviate youth unemployment. These steps are welcome. But an independent Scotland will have several options to do more.

In fact, some of the options already outlined in this paper would help. For example, some of the choices we suggested under social security would directly assist young peoples' transition into the labour market. If Scotland were successfully running its own monetary policy, this would reduce the current adverse effects on Scotland of dominance by the overheated South East. Rebased the economy to give a healthier manufacturing sector would assist young people.

In addition, there are further options which a Scottish government might choose to implement. Options for consideration include:

- a) modifying an initiative used in France, under which a portion of VAT receipts was earmarked for local initiatives. This could be used to fund training courses for young people, and could provide funding for extra curricular courses at school to help young people to become ready for the job market.
- b) bringing back industrial training boards: The Industrial Training Act, which came into force in Great Britain in 1964, gave the Minister of Labour statutory powers for the establishment of Industrial Training Boards. The Boards oversaw training, set standards, and recommended appropriate further education. The Boards were financed by compulsory

levies on member firms, and they paid allowances to trainees. The Boards were criticised for being backward and too set in their ways in their training programmes, and by the 1990s all but the Construction Industry Training Board had died. Nevertheless, training boards work successfully in a number of countries, for example, France and Australia: and it is also clear that in the absence of training boards, there has been a persistent failure of industry to play its part in training a sufficient supply of skilled workers. Properly managed, there is no reason why re-established training boards in Scotland should not have a lot to offer.

- c) The courses suggested at (a) could be run by the training boards.
- d) appropriate conditions could be written into contracts for government procurement to make sure that suppliers employed young people on a reasonable basis. For example, it is currently a requirement in some PFI projects that a number of apprenticeships are provided in construction: similar requirements could be built into all sizeable service contracts let by government and government agencies. There could also be a ban on zero hour contracts. Similar conditions could be built into future resource licensing arrangements.

SECTION 2: THE CONTEXT WHICH WILL DETERMINE HOW THESE POWERS ARE EXERCISED

In the previous section, we outlined various areas within which an independent Scotland could exercise its powers: and within each area, we looked at some of the choices it would have, and some of the things it might like to do. But listing individual powers like this only tells part of the story. In deciding how it is going to exercise its economic powers, a Scottish government will inevitably be hugely influenced by a number of other factors. In particular,

- a) It will want to ensure that it co-ordinates its different economic policies in a way which is consistent with its vision for the type of social and economic model it wants to achieve: so choice of basic social/economic model is a fundamental decision which will underpin the exercise of individual powers.
- b) No government has complete freedom of action: all governments find themselves acting within a variety of constraints. In fact, for a newly independent Scottish government these constraints are likely to fall into two classes. First of all, there are those constraints which have been voluntarily accepted as part and parcel of a negotiated constitutional

settlement: an example would be the conditions which an independent Scotland might agree to if it wanted to be a member of a Sterling monetary union. Secondly, there are going to be inherent constraints which an independent Scotland might face anyway – in particular, the normal governmental problem that all policy initiatives cost money, and only so much can be done at any one time with inevitably finite resources.

- c) In addition, policy is in any event hugely conditioned by, in Harold Macmillan's famous phrase "events, dear boy, events." Events beyond the control of the Scottish government are likely to determine when, and how, it is appropriate for the Scottish government to develop key parts of its economic policies. This is particularly the case, as we will see, for any decision to adopt an independent Scottish currency.

In the following sub-sections we will look at each of these areas in more detail.

SOCIO-ECONOMIC MODELS

Underpinning every decision which an independent Scottish government will make would have to be fundamental choices about what sort of society and economy Scotland wanted to develop. In particular, where is the economic product of the country going to come from? And what is the role of the state in creating the required environment to deliver that product, and in influencing its distribution?

As regards the first of these questions, decisions would have to be made about what the desired balance should be between natural resource exploitation, knowledge based industry, and services, (with particularly difficult decisions about what role the financial services sector should play).

As regards the role of the state, the choices are wide. On the one hand, there is the neo-liberal model, with a small state and low taxes, and the hope that the market will deliver both economic growth, and a socially just distribution of the economic product. At the other extreme, there is the command economy approach, with the state heavily involved both in planning and control of economic activity, and in deciding on the distribution of the product. Or there are a variety of middle course approaches which seek to combine relative economic liberalism with the state intervening to achieve what society regards as a fair distribution of the economic product. It is in this area that the Common Weal model, proposed by the Jimmy Reid Foundation sits.

All approaches tried so far have had their problems. Ultimately, the choice of model is for the Scottish people. The important point for present purposes is that every decision an independent Scottish government would make on the operation of its economic powers would be fundamentally conditioned by society's basic decisions about choice of socio-economic model.

CONSTRAINTS

But choice of socio-economic model is not the only factor which will condition the actions of an independent Scottish government: it will also be faced by a variety of constraints. Some of these constraints will have been willingly accepted as part of the process of negotiating a final political settlement: others will be inherent.

An example of the former type of constraint would be the conditions which Scotland would have to accept if it were to choose to be a member of a UK monetary union after independence. It is not just that such an arrangement would, by definition, mean giving up sole responsibility for monetary policy. In addition, such an arrangement would have to involve very close co-ordination of financial supervision and stability arrangements between the parties involved: and also restrictions on both parties' ability to operate their fiscal policies. This would probably entail not just limits on the maximum allowable levels of public sector debt and deficit, but also limitations on the ability to vary specific taxes within very restrictive ranges. Almost certainly, for example, given the close geographic confines of the British Isles, the rest of the UK would insist on negotiating the terms for any UK currency union so that Scotland would not have unfettered freedom to vary corporation tax. It is a very good question, therefore, whether the constraints which Scotland, (and for that matter the rest of the UK), would have to concede in order to establish a joint UK currency union would actually be consistent with any meaningful form of independence. But it is certainly the case that the constraints involved in such an arrangement are currently unknowable, so that the economic policy options open to a Scottish government in a UK currency union are largely a matter of guesswork.

Similar considerations apply to the situation in which an independent Scotland chose to be a member of the EU. Some of the constraints involved in EU membership, (like adherence to the current EU Directives), are known, because we already adhere to them. But the details of the path Scotland would need to

take to full EU membership are currently unclear: and if Scotland were forced to go down an accession route, this would involve negotiation. Scotland would be in a strong position in these negotiations, given it would hold the cards of controlling major natural resources and fisheries: and if the EU was seeking to impose too many burdensome requirements, then there are other options Scotland could explore, like membership of EFTA. Overall, the important point is that it is currently unknowable what concessions Scotland might wish to make in negotiations with the EU.

In addition to those constraints which might be agreed to as part of a negotiated constitutional settlement, other constraints will be inherited as a legacy of decisions made by pre-independence administrations. One example would be commitments to pay subsidies for the supply of renewable energy: another would be contractual payments made under PFI.

Finally, there will be inherent constraints of the kind which limit the freedom of action of all governments. One would be the need to act sufficiently prudently so as to maintain the confidence of the bond markets, so that a future Scottish government could borrow at reasonable rates. Another constraint will be the standard governmental problem of scarce resources to fund public expenditure.

PUBLIC EXPENDITURE RESOURCE CONSTRAINTS.

It is worth looking at this question of resources in more detail. One conventional starting point for this type of analysis is what the annual publication of Government Expenditure and Revenues in Scotland (GERS) , (Scottish Government, 2013), tells us about the fiscal position of Scotland under the present constitutional settlement. The following tables, taken from GERS, show for Scotland and for the UK the current budget balance, and the overall net fiscal balance, expressed as a percentage of GDP.

The current budget balance is the difference between public sector current revenues and public sector current expenditure: it measures the degree to which present taxpayers meet the cost of paying for the public services they use, including capital depreciation and a contribution to debt interest payments. This was the measure used by Gordon Brown in setting his Golden Rule on government finances. The net fiscal balance is the difference between public

sector total expenditure, including capital expenditure, and total revenue. It is common for the total fiscal balance to be in some level of deficit, to the extent that a nation is investing in productive activities and assets for its future. The net fiscal balance is that used in setting the Maastricht criteria. The figures in the table have been calculated under the assumption that Scotland receives its geographical share of North Sea oil revenues – which is what an independent Scotland would receive under the Geneva Convention.

Scotland and UK: Balance on Current Budget as Percent GDP.

Year	2007-08	2008-09	2009-10	2010-11	2011-12
Scotland	-0.3	0.7	-7.2	-5.3	-2.3
U.K.	-0.5	-3.6	-7.8	-6.9	-6.0

(positive sign indicates surplus)

Scotland and UK: Net Fiscal Balance as Percent GDP.

Year	2007-08	2008-09	2009-10	2010-11	2011-12
Scotland	-2.9	-2.6	-10.7	-8.1	-5.0
U.K.	-2.6	-6.9	-11.2	-9.5	-7.9

Sources: GERS 2011-12, Table 2.2c and Box 2.1

The tables show how both Scotland and the UK have been pushed into serious deficit by the financial crisis starting in 2008: and also how, over the period shown, Scotland's current deficits have been consistently smaller than the UK's, and the deficit on Scotland's net fiscal balance has also been smaller than that for the UK with the exception of 2007-08.

Figures from GERS, however, are not a good guide as to what the budgetary position of an independent Scotland would be post independence. For one thing, in at least one important respect, the approach adopted in GERS towards estimating public expenditure for Scotland overstates the probable expenditure commitments of an independent Scotland. This occurs in relation to defence expenditure. In GERS, defence expenditure is treated as "non-identifiable": that

is, it is regarded as being incurred for the benefit of the UK as a whole, and is allocated to Scotland on a per capita share basis. The result is that Scotland is assumed in GERS to spend 2.2% of its GDP on defence: (note that this does not mean that this money is actually spent here: this figure is based on a population share of what the UK spends). On the other hand, figures from the World Bank indicate that small independent countries broadly comparable to Scotland typically spend much less than this on defence: for example, Ireland, 0.6%: New Zealand, 1.1%: Denmark, 1.4%: and Norway, 1.6%.

A similar issue arises in relation to what is described in GERS as international services, (mainly international aid), where the population share of UK expenditure attributed to Scotland amounts to 0.5% of Scottish GDP. Of course, an independent Scotland may well want to undertake foreign aid – but that would be a decision for the future, so it is wrong to implicitly carry over to a post independence Scotland the population share of UK expenditure which GERS attributes to us.

The implication is that, because of the way that defence and overseas services are handled, the current GERS overstates by 1.5% of GDP or more the fiscal deficit of an independent Scotland. This is a significant amount given that the Maastricht criteria, for example, imply that the fiscal deficit should not exceed 3%.

Of course, in the move to independence, much else would change as well. Scotland would have to take on new expenditures, and revenue streams might alter. The importance of the way defence and international services are treated in GERS is that an independent Scotland would actually have significant leeway to incur transitional costs, before its fiscal position became any worse than the way it is presently calculated in GERS.

While GERS is therefore a poor guide to what the fiscal position of an independent Scotland would look like, certain implications are clear.

- First of all, in common with the rest of the UK, an independent Scotland would have to take steps to overcome the deficit situation.
- Secondly, given the current importance of oil revenues, an independent Scotland would have to pay extremely close attention to maximising the benefits that the Scottish economy in general, and Scotland's public sector revenues, receive from Scotland's oil resources. These resources are significant: total UK reserves are estimated at between 15 and 24 billion barrels, according to Oil and Gas UK's 2012 Economic Report, of which about 85% is estimated to be in Scottish waters, (Fiscal Commission, 2013). However, these resources would have to be exploited much more in Scotland's interests than has been the case in the past. As was pointed out by Professor Odell in 2010, (an emeritus professor of energy at Erasmus University in Rotterdam), the UK was almost unique among major oil producers in not having a state controlled strategic oil authority to control oil exploration and production. This is a deficiency which an independent Scotland would almost certainly choose to rectify.
- Similar considerations also apply to whisky. As noted above, almost two thirds of the total turnover of the whisky industry is taken as profit and return on capital, and very little of this stays in Scotland. This situation needs to be redressed.

UNCERTAINTIES

The environment facing Scottish policy makers will be hugely influenced by the future course of events: these unknowables will impact not just on the feasibility of certain policy options – but also on their timing.

One example relates to the question of how much of the UK's public sector debt an independent Scotland will inherit. Inherited debt is often suggested as one of the critical stumbling blocks on the path towards Scottish independence: but, as we will see, this is by no means necessarily the case.

In normal times, an advanced country like the UK would be expected to have incurred most of its debts to cover productive investment in public infrastructure: so that the value of the assets of the state would normally exceed its debts. This was indeed the case for the UK: at end 2007, for example, the net

worth of general government in the UK, (that is, the extent to which the value of government assets exceeded its debt), was substantially positive, at £358.9 billion, as published by ONS in “The National Balance Sheet”, 2012 results. In normal times, the process of dividing up the debt of the UK when Scotland became independent would be the counterpart of dividing up the assets of the UK – so that both parties emerged with a comfortable positive net worth. This is the process envisaged under the terms of the Vienna Convention of 1983, and while it would involve tough negotiations, it would be expected that both parties would emerge profitably, and well satisfied, from the eventual outcome.

Of course, times in the UK are now not normal, with the public sector debt of the UK at £1189 billion, or 76% of GDP, and rising, (according to estimates by the Office of Budget Responsibility for the year 2012/13), and with the net worth of UK general government now substantially negative, at -£259.3 billion in 2011. It is highly likely, however, that some event or other in the near future will significantly change the real value of the UK’s public sector debt. The most likely possibility is that the UK simply monetises a large part of its debt. It is already, in fact, a good way down this road. Under quantitative easing, the UK has printed money, and bought a significant part of its debt back: the amount of debt bought back like this was £375 billion by February 2013, (Bank of England, 2013). The official stance is that this is a temporary move, and that these debt certificates will in due course be sold again when economic conditions improve. However, serious commentators on the British economy are now finding this increasingly unlikely. For example, Ambrose Evans Pritchard, writing in the Telegraph on 9th August about the possibility of the Bank of England simply cancelling the debt certificates it had bought under quantitative easing, said, “It is what the Bank of England is likely to do here (while denying it).”

So monetisation of a significant part of the UK’s debt is increasingly regarded as a very real possibility. Other possibilities which cannot be discounted are outright default by the UK, or substantial erosion of the real value of the UK’s debt by inflation. While the exact course of events is unknowable, the important point is that it cannot be assumed that the UK’s current real burden of debt will continue at present levels. The implication is that the current size of the UK’s public sector debt should not be taken as a critical argument against Scottish independence.

Future contingencies will also be critical in determining when and how an independent Scotland could make a transition to its own currency. The transition from a monetary union to a separate currency is, by common consent, a difficult step. In effect, all of the contracts written in the old currency have to be renegotiated, in a situation where the different sides in these contracts will take

different views about who is being penalised and who is gaining. In normal circumstances, the least traumatic approach is likely to involve one currency being pegged to the other for a lengthy transitional period – and then, in due course, the peg being moved or relaxed. But suppose circumstances are not normal. Suppose there was a future systemic UK financial crisis, in which Sterling itself was being debased. In these circumstances holders of contracts denominated in Sterling might find it very attractive to have their contracts redenominated in a new Scottish currency: a currency backed ultimately by Scotland's natural resources, and by the talents of its people, (as is the case with most sound currencies). And such a UK crisis is certainly possible: after all, the UK came very close to a systemic crisis in 2008 – and the fundamental problems leading to that situation are far from resolved.

Similar considerations apply to the establishment of an independent system for ensuring the stability of the financial sector. The ease of doing this will depend very much on to what extent UK arrangements are regarded as viable at the relevant time.

SECTION 3: IN CONCLUSION

As has been shown in Section 1, there are many ways in which, under the present constitutional settlement, the way the major economic policy levers are operated is very sub-optimal for Scotland. And as Section 1 also demonstrates, for each of these policy levers an independent Scotland has plenty of scope to do much better.

However, the analysis in Section 2 also has important implications, namely,

- a) Fundamental to all economic policy making by an independent Scotland would be basic decisions about what sort of society and economy we want to achieve.
- b) Scotland has to be very careful that in negotiating its relations with bodies like the rest of the UK and the EU, it does not make concessions which will impose constraints which ultimately prove to be crippling. Any choices, for example, about forming a Sterling currency union with the rest of the UK would have to be viewed very carefully in this respect.
- c) An independent Scotland is going to have to have the will and courage to deal with the other constraints it will face. In particular, it will have important choices to make about how it is to ensure that Scotland gets a fair share of the benefit from its natural and other resources.
- d) Scotland will have to be pragmatic and opportunistic about how it responds to the uncertain course of world economic events. In particular, it will wish to avoid the risk of being damaged by any potential crisis in the rest of the UK, while being able to respond to possible opportunities, for example, for easing the transition to an independent currency.

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