



SELECT COMMITTEE ON ECONOMIC AFFAIRS

**The Economic Implications for the United Kingdom of
Scottish Independence**

Oral and Written Evidence

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HOUSE OF LORDS

Professor Robert Rowthorn—Written evidence

The Fiscal Implications of Scottish Independence

Abstract

This submission examines the fiscal implications of Scottish independence for both Scotland and the rest of the UK. These would depend of a number of factors, including world hydrocarbon prices, the extent to which an independent Scotland accepted responsibility for its proportionate share of the UK national debt, and what happened to the Orkney and Shetland Islands. A number of scenarios are considered on the assumption that Scotland becomes independent soon after a hypothetical ‘yes’ vote in the 2014 referendum. At one extreme, Scotland would have a fiscal deficit approaching 6 percent of GDP. This would be the case if hydrocarbon prices fell sharply, the Orkneys and Shetlands remained in the UK, and Scotland shouldered its full share of the national debt. Under these conditions, Scotland might face a funding crisis and the UK might have to step in to help, just as it is currently helping to bail out Ireland. At the other extreme, Scotland might have a small fiscal surplus. This would be the case if hydrocarbon prices remained buoyant, the Orkneys and Shetlands stayed within the Scottish fold and if Scotland took no responsibility for the UK national debt and associated interest payments. In fiscal terms, the rest of UK might gain or lose from the departure of Scotland, but the effect would be small – less than 0.5 percent of GDP either way.

Introductory Remarks

Scottish independence would affect the rest of the UK economy and government finances in a variety of ways. The following are some of the most important items that are relevant in this context.

Economic Cooperation: Given an amicable dissolution, independence should not have a serious impact on economic cooperation between Scotland and the rest of the UK. Trade and investment would continue much as before, although the exact outcome would depend on Scotland’s choice of currency and its broader economic policy. It is unlikely there would be a repetition of the trade war which marred Anglo-Irish economic relations during the 1930s.

Currency: Scotland would have a number of options following independence. SNP leader Alex Salmond has stated that an independent Scotland would keep sterling for the time being, but would keep its options open for the future¹. If permitted, it could join the euro. Or it could have its own currency, which could either float or else shadow the pound or the euro. Each of these options would have somewhat different economic implications for Scotland and also for the UK.

The National Debt: When the Anglo-Irish Treaty was signed on 6th December 1921, the newly formed Irish Free State agreed to assume responsibility for a proportionate part of the

¹ Channel 4 News, 11 January, 2012. <http://www.youtube.com/watch?v=SpKVK6DI7OQ>

United Kingdom's debt, as it stood on the date of signature². It is probable that similar arrangements would be made following Scottish independence. In a recent TV interview, Alex Salmond stated that an independent Scotland would take its proportionate share of the national debt, although this cannot be taken for granted³. He also stated that Scotland would take no responsibility for the outstanding debts of the Royal Bank of Scotland, citing in justification the £250 billion of mainly Scottish oil revenue that has gone to the UK Treasury since production began in the North Sea. By the time of independence, assuming a 'yes' vote in a 2014 referendum, Scotland's per capita share of the UK national debt might be in the region of £120 billion, and associated interest payments around £5 billion a year. Faced with the prospect of interest payments on this scale, it would be rational for the nationalists to seek to minimize Scotland's responsibility for the national debt.

Defence: Military arrangements would alter following Scottish independence. Scotland would take over some existing military facilities and would finance its own armed forces. In response, the UK might reduce its own defence expenditure, or alternatively might continue spending as much as before so as to preserve its previous military capacity. There might also be some form of military cooperation between the Scotland and post-independence UK. One bone of contention would be the Faslane naval base on Gare Loch which serves as home base for the UK fleet of Trident submarines as well as conventionally-armed nuclear powered submarines. There has been ongoing agitation against this base and its future would be uncertain. If the government of an independent Scotland insisted on the removal of these submarines they would have to be relocated elsewhere. Alternatively, the new Scottish government might allow the UK to retain the Faslane base, following the example of the Ukrainian government which allowed the Russians to keep their naval base in Sevastapol after the break-up of the Soviet Union. This would be economically advantageous for Scotland, both in terms of the jobs it would provide and any rent that Scotland might receive.

North Sea Oil and Gas: Under the international law of the sea Scotland would be entitled to an exclusive economic zone (EEZ) covering a significant area of the North Sea⁴. This would give Scotland access to substantial tax revenues that currently accrue to the central UK government. The Scottish government has estimated what the effect would be on the assumption that what it calls the "geographical share" of oil-related production and revenue is assigned to Scotland⁵. This share is based on the "median line", which projects outwards into the North Sea from the coastline at the boundary between England and Scotland. This is the area that might belong to Scotland's exclusive economic zone in the event of independence. It is estimated that approximately 90 percent of current UK North Sea revenue derives from resources located within this area.

The Orkney and Shetland Islands: There is concern in the Orkney and Shetland islands about membership of an independent Scotland, and in the event of Scottish independence it is

² Article 5 of the Anglo-Irish Agreement states: "The Irish Free State shall assume liability for the service of the Public Debt of the United Kingdom as existing as the date hereof and towards the payment of War Pensions as existing at that date in such proportion as may be fair and equitable, having regard to any just claim on the part of Ireland by way of set-off or counter claim, the amount of such sums being determined in default of agreement by the arbitration of one or more independent persons being citizens of the British Empire".

http://www.nationalarchives.ie/topics/anglo_irish/dfaexhib2.html

³ Channel 4 News, 11 January, 2012. <http://www.youtube.com/watch?v=SpKVk6DI7OQ>

⁴ Eric LeGresley (1993): *The Law of the Sea Convention*, Library of Parliament Research Branch, Ottawa, Ontario, Canada. <http://publications.gc.ca/Collection-R/LoPBdP/BP/bp322-e.htm>.

⁵ *Government Expenditure and Revenue Scotland 2010-2011*, Scottish Government, March 2012, table 3.1.

conceivable that these islands would opt to remain part of the UK⁶. The Scottish National Party has conceded that this would be a feasible option for the islanders⁷. It would have important implications for the control of North Sea oil and gas. According to the normal principles of international law, there would be an exclusive economic zone around the Orkneys and Shetlands if they were to remain within the UK. This would give the UK control of part of the North Sea that would otherwise be under Scottish control. The fact that the Orkneys and Shetlands are located close to Scotland but several hundred miles from the English shore is no obstacle to them remaining in the UK, nor under international law does it prevent the UK from having an EEZ based on these islands. The exact boundaries of such an EEZ are uncertain and would have to be settled by negotiation between the parties involved. Media reports claim that a quarter of current UK North Sea revenue derives from resources located within the potential EEZ of the Orkneys and Shetlands. This is about 30 percent the North Sea revenue that Scotland might otherwise expect to enjoy following independence.

Structure of the Paper

The structure of this paper is as follows. It begins with a brief comparison of the recent fiscal situation in Scotland and the rest of the UK. This confirms the conventional view of Scotland as a high spending country of the UK. Next there is section which projects Scottish government expenditure and revenue forwards to 2016-17. The numbers presented are the author's own estimates. There is then a section on the fiscal implications of independence for Scotland. This is followed by a discussion of the fiscal implications for the rest of the UK. These sections are linked; since in most cases Scotland's fiscal gain or loss following independence is matched by an equal but opposite change in the fiscal balance of the rest of the UK. For example, if an independent Scotland takes responsibility for a certain category of expenditure, this will no longer be a UK responsibility and will no longer be included in the UK national accounts. The paper concludes with a few general observations. The main conclusion is that a newly independent Scotland would probably have a fiscal deficit, although there is considerable uncertainty regarding the scale of this deficit. Two factors would be of particular importance in this context: the future behaviour of oil and gas prices; and the extent to which an independent Scotland accepted responsibility for its proportionate share of the UK national debt. A second, and more obvious, conclusion is that Scottish independence would have only a minor effect on the UK fiscal situation. A loss or gain, which is highly significant for a small economy like Scotland, is much less important to a much larger economy like post-independence UK.

A Comparison

A useful starting point to analyse the fiscal impact of Scottish independence are the official public sector accounts for Scotland, henceforth known as GERS⁸. This document gives detailed information of Scottish expenditure and revenue, together with estimates of Scotland's "geographical" share of North Sea revenue. It also contains extensive data for the UK as a whole.

⁶ Tavish Scott MSP and Liam McArthur MSP: *Scotland's Constitutional Future – Northern Isles: A response to the UK Government's Referendum Consultation*, March 2012.

⁷ BBC interview with Angus MacNeil, the SNP's rural affairs spokesman, reported in the *Daily Telegraph*, 20 March, 2012.

⁸ *Government Expenditure and Revenue Scotland 2010-2011*, Scottish Government, March 2012.

<http://www.scotland.gov.uk/Publications/2012/03/9525/0>

Table I presents information on per capita expenditure and revenue in Scotland and the rest of the UK for the fiscal year 2010-2011. Expenditure includes both current and capital items. It is divided into two broad categories: identifiable and non-identifiable. The former is expenditure which is clearly associated with a specific country, and includes virtually all expenditures on health, education, social protection, transport, public order and safety. Non-identifiable expenditure is expenditure that cannot be associated with particular country of the UK but is instead incurred on behalf of the UK as a whole. In the public sector accounts, most non-identifiable expenditures are conventionally assigned to individual countries in proportion to their share in UK population. This convention explains why per capita defence and interest payments in table I are the same in Scotland and the rest of the UK.

Table I: Expenditure and Revenue 2010-2011

£ per capita		
	Scotland	Rest of UK
Identifiable expenditure	10,051	8,718
Interest	708	708
Defence	625	625
Other non-identifiable expenditure	402	510
Total expenditure	11,785	10,560
Current non-North Sea revenue	8,640	8,709
North Sea revenue:		
Per capita shares	141	141
Geographical shares A	1,521	15
Geographical shares B	1,100	53
Total revenue:		
Per capita shares	8,780	8,850
Geographical shares A	10,160	8,724
Geographical shares B	9,740	8,762
Net fiscal balance:		
Per capita shares	-3,005	-1,711
Geographical shares A	-1,625	-1,837
Geographical shares B	-2,405	-1,798

Source: Author's own calculations based on GERS.

Government revenue from the North Sea is shown separately in table I. This is assigned to countries in three different ways. These correspond to different assumptions about the

ownership of North Sea resources and about the identity of the Orkney and Shetland Islands. In the assignment labelled “Per capita shares”, Scotland receives slightly more than 8 percent of UK North Sea revenue, in accordance with its share in total UK population. This assignment assumes that North Sea hydrocarbons belong to the UK as a whole and that no individual country of the union has a privileged claim over the revenue they generate. The assignment labelled “Geographical shares A”, assumes that North Sea hydrocarbons belong mainly to Scotland, and the revenue from these is allocated according to the principles of territorial control applicable if Scotland were an independent country. GERS estimates that in this case Scotland would get about 90 percent of total UK revenue from the North Sea. This leaves the rest of the UK with very little. In the assignment labelled “Geographical shares B”, Scotland excludes the Orkney and Shetland Islands which are classified as part of the rest of the UK. The share of these islands in UK North Sea revenue is assumed to be 25 percent.

It is well-known that Scotland is a high spending country. This is clear from table 1. Identifiable per capita expenditure is £1,300 a year (15 percent) greater in Scotland than the average for the rest of the UK. Amongst the biggest contributors to the high level of spending in Scotland are social protection, transport, health and housing in that order. The implications of this difference in expenditure depend on what is assumed about the allocation of North Sea revenue. If this revenue is allocated according to population shares, total revenue per capita is similar in Scotland to the rest of the UK, and there is nothing to offset higher Scottish spending. As a result, the per capita fiscal deficit is £1,300 larger in Scotland than in the rest of the UK. The other scenarios allocate most North Sea revenue to Scotland. This modification has dramatic results. It increases Scotland’s North Sea revenue from £141 per capita to £1,521 or £1,100 depending on how the Orkneys and Shetlands are classified. This increase is sufficient to offset most or all of the difference in expenditure between Scotland and the rest of the UK. Even so, the Scottish fiscal deficit is still very large. Note that under any scenario, the per capita fiscal deficit of the rest of the UK is virtually the same. This is because the population of the UK is so large. On a per capita basis, a few billion pounds of oil revenue makes a big difference to Scotland, but spread over 57 million people in the rest of the UK the effect is relatively small.

Scotland’s Future Expenditure and Revenue: within the UK

Table 2 contains some projections for Scottish government expenditure and revenue up to 2016-17. These projections are derived from official accounts which assume that Scotland remains in the UK. The numbers for 2010-11 come from GERS and are projected forwards on the basis of Office for Budget Responsibility (OBR) projections for the UK as a whole⁹.

⁹ OBR’s *Economic and fiscal outlook: selected tables*, http://cdn.hm-treasury.gov.uk/budget2012_annexd.pdf.

With the exception of North Sea revenue, each category of per capita expenditure and revenue is assumed to grow at the same percentage rate in Scotland as in the UK as a whole. The share of defence in Scottish total expenditure, excluding interest, is assumed to remain constant at the 2010-2011 level (5.1%). Scotland is allocated its 2010-11 "geographical" share of total UK North Sea revenue (90.5%).

Table 2. Scottish Net Fiscal Balance 2010-11 to 2016-17

	£ billion		
	2010-11	2015-16	2016-17
(1) Public sector debt interest	3.7	5.1	5.4
(2) Defence	3.3	3.6	3.6
(3) Other expenditure	56.8	60.9	61.5
(4) Total expenditure	63.8	69.6	70.5
(5) Non-North Sea revenue	45.2	56.4	59.9
(6) North Sea revenue (geographical share)	8.0	5.4	4.7
(7) Total revenue	53.1	61.8	64.6
(8) Net fiscal balance (= row (7) - row (4))	-10.7	-7.8	-5.9
<i>Balance as % Scottish GDP (incl. oil)</i>	<i>-7.4</i>	<i>-4.7</i>	<i>-3.5</i>
<i>Balance as % of UK GDP</i>	<i>-0.7</i>	<i>-0.4</i>	<i>-0.4</i>
<i>Memo:</i>			
<i>UK Balance as % of UK GDP</i>	<i>-9.2</i>	<i>-2.8</i>	<i>-1.1</i>
Source: GERS, OBR and author's own calculations			

Scotland is assigned a constant “geographical” share of North Sea revenue equal to 90.5 percent, which is the share given by GERS for 2010-2011. The method of estimation used for table 2 is elementary but, hopefully, the projections are of the right order of magnitude. It must be stressed that these projections assume that the OBR projections for the UK as a whole are correct.

Points to note are as follows:

- Under the impact of Chancellor Osborne’s deficit reduction programme, the UK fiscal deficit virtually disappears by the end of the period. From 9.3 percent in 2010-11 it falls to only 1.1 percent of GDP in 2016-17. This may turn out to be overoptimistic.
- The Scottish deficit also declines but at a slower pace, and even by the end of the period it is still 3.5 percent of GDP.
- The slow pace of decline in Scotland’s deficit is partly due to the assumed behaviour of North Sea revenue. Such revenue falls rapidly during the last few years of the OBR projection and by the end of the period is only half what it was at the beginning in real terms. This development is explained in part by a combination of falling production and falling prices for North Sea hydrocarbons from 2012-13 onwards. The two are, of course, linked. With higher prices, there would be more production

in the North Sea, and the decline in revenue might be halted or even reversed for a significant time¹⁰.

Fiscal Implications for an Independent Scotland

The projections in table 2 give some indication of the fiscal situation facing a newly independent Scotland. However, certain modifications are required to get a complete picture. Table 3 presents three alternative scenarios for the year 2015-16, which is the first fiscal year following the planned 2014 independence referendum. In this table, the baseline fiscal balance, which is given in table 2, is adjusted in various ways. The quantitative adjustments are hypothetical and are designed to illustrate the potential orders of magnitude.

**Table 3. An Independent Scotland: Net Fiscal Balance 2015-2016
Alternative Scenarios**

£ billion	Intermediate Scenario	Best Case Scenario	Worst Case Scenario
Baseline balance	-7.8	-7.8	-7.8
Adjustments:			
Defence expenditure	+1.2	+ 1.2	+1.2
Interest payments	0.0	+5.1	0.0
North Sea revenue:			
Orkneys & Shetlands	0.0	0.0	-1.5
Production & prices	+2.6	+2.6	-1.3
Total adjustments	+3.8	+8.9	-1.6
Final balance	-4.0	+1.1	-9.4
% Scotland GDP	-2.4	+0.7	-5.9

Under the best case scenario, Scotland gains in three different areas as follows:

- *Defence:* an independent Scotland is content with modest armed forces along Nordic lines. It has no need for costly aircraft carriers or Trident submarines. The assumed savings are £1.2 billion a year, which is about a third of the Scotland’s notional share of UK defence expenditure.
- *Interest:* The nationalists take no responsibility for Scotland’s share of the UK national debt, thereby avoiding annual interest payments equal to £5.1 billion.
- *North Sea revenue:* Hydrocarbon prices and production remain buoyant. In money terms Scotland’s North Sea revenue is the same in 2015-16 as it was in 2010-2011. This represents a gain for Scotland of £2.6 billion as compared to the baseline scenario, which assumes falling revenue from this source.

After these favourable adjustments there is a fiscal surplus in 2015-16 equal to £1.1 billion or 0.7 percent of Scottish GDP.

¹⁰ The relationship between prices and production is examined in Kemp, A. G. & Stephen, L. (2011). 'The Short and Long Term Prospects for Activity in the UK Continental Shelf: the 2011 Perspective'. North Sea Study Occasional Paper, vol. 121, pp. 1-61.
http://aura.abdn.ac.uk/bitstream/2164/2132/1/nsp_121.pdf.

The worst case scenario retains the savings on defence expenditure, but makes the following assumptions about the remaining items:

- *Interest*: The nationalists accept Scotland's full per capita share of the UK national debt, so there are no savings on this item for Scotland.
- *Orkneys and Shetlands*. These islands remain within the UK and Scotland loses 30 percent of its North Sea revenue. This represents a loss for Scotland of £1.5 billion.
- *Prices and production*: Hydrocarbon prices and production are lower than envisaged under the baseline scenario. As a result, revenue from the North Sea falls by a further third in addition to the loss due to the exclusion of the Orkneys and Shetlands from the Scottish fold. This represents an additional loss of around £1.3 billion¹¹.

Under this scenario the fiscal deficit is equal to £9.4 billion which is equivalent to 5.9 percent of Scottish GDP.

There is also an intermediate scenario in which Scotland accepts responsibility for its per capita share of the UK national debt, but North Sea revenue remains buoyant because of high hydrocarbon prices and the Orkneys and Shetlands remain in the Scottish fold. In this scenario, there is a modest fiscal deficit equal to 2.4 percent of Scottish GDP, which is a little smaller than the UK deficit in the same year.

Table 3 reveals the range of potential outcomes. Under the best case scenario, Scotland has a small fiscal surplus. Its high level of expenditure on health, education, transfer payments and the like is more than offset by buoyant North Sea revenue and savings in interest payments. Under the worst case scenario, Scotland has a large fiscal deficit. The government's expenditure continues at a high level, but North Sea revenue has fallen sharply and it must also service a large inherited national debt.

Fiscal Impact on the UK

In most cases, the fiscal impact of Scottish independence on the UK is equal in magnitude but opposite in sign to its impact on Scotland. If Scotland receives North Sea revenue that would otherwise have gone to the UK government, this will represent a loss for the post-independence UK. Conversely, if Scotland takes responsibility for some item of expenditure, this will normally imply a saving for the UK. For example, if Scotland takes over responsibility for a share of the UK national debt, Scotland's resulting interest payments will be matched by an equal reduction of UK interest payments. However, this one to one correspondence may not be universally valid. In the official UK accounts for Scotland on which table 2 is based, government expenditure contains a notional allowance for non-identifiable expenditures on items such as defence and international services. Many of these items are "public" goods whose benefit to the rest of the UK is largely unaffected by whether or not Scotland becomes independent, or by what an independent Scotland would spend on them. Following the departure of Scotland, there would be scope for the UK to make some economies in this area, but major reductions would damage UK military capacity or its ability to provide other central government services.

¹¹ The figure of £1.3 billion is one third of Scotland's projected North Sea revenue excluding the Orkney and Shetland islands.

Table 4 shows three scenarios for the change in the UK fiscal balance due to Scotland’s departure. The numbers refer to the fiscal year 2015-16. The first line is the baseline change which is taken directly from table 2, with the sign reversed. In all three scenarios, following the departure of Scotland, the UK continues to spend approximately 80 percent of the amount notionally allocated to Scotland in the official accounts for non-identifiable expenditures, excluding interest payments. This reduces the expenditure savings when Scotland leaves by £5 billion. The scenarios differ in their assumptions about interest and North Sea revenue.

Note that the adjustments for interest and North Sea revenue in table 4 are the mirror image of those shown for Scotland in table 3. For example, if there is a reduction in Scotland’s North Sea revenue due to lower oil prices, the fiscal effect is denoted by a minus sign in table 3 and a plus sign in table 4. The plus sign indicates that, if oil prices are low, Scotland’s departure implies a smaller loss of North Sea revenue for the UK than if oil prices are high. Note also that the labelling of scenarios is reversed. The worst case scenario for the UK is the best case scenario for Scotland and vice-versa.

Table 4. The Impact of Scottish Independence on the UK Net Fiscal Balance: 2015-2016

Alternative Scenarios £ billion	Intermediate Scenario	Worst Case Scenario	Best Case Scenario
Baseline change in balance (= <i>minus</i> line (7) of table 2)	+7.8	+7.8	+7.8
Adjustments:			
Defence and other non-identifiable expenditure	-5.0	-5.0	-5.0
Interest payments	0.0	-5.1	0.0
North Sea revenue:			
Orkneys & Shetlands	0.0	0.0	+1.5
Production & prices	-2.6	-2.6	+1.3
Total adjustments	-7.6	-12.7	-2.2
Final change in balance	+0.2	-4.9	+5.6
<i>% UK GDP</i>	<i>+0.0</i>	<i>-0.3</i>	<i>+0.3</i>

The worst case scenario (from the UK point of view) makes the following assumptions:

- *Interest:* The nationalists accept no responsibility for Scotland’s share of the national debt and related interest payments. This reduces the annual savings to the UK resulting from Scotland’s departure by £5.1 billion.
- *Orkneys and Shetlands:* These islands leave the UK to become part of an independent Scotland, No adjustment to the baseline scenario in table 2 is therefore required.
- *Prices and production:* Hydrocarbon prices and production remain buoyant. As a result, the UK loses more North Sea revenue when Scotland leaves than is envisaged under the baseline scenario. The additional loss is £2.6 billion, which is equal the gain to an

independent Scotland from higher hydrocarbon prices and production as shown in table 3.

Under this scenario, the change in the UK net fiscal balance due to Scotland's departure is -£4.9 billion or -0.3 percent of GDP.

The best case scenario (from the UK point of view), makes the following assumptions:

- *Interest:* The nationalists accept full responsibility for Scotland's share of the national debt and related interest payments. No adjustment to the baseline scenario in table 2 is therefore required.
- *Orkneys and Shetlands:* These islands remain in the UK along with the rest of Scotland. This reduces Scotland's entitlement to North Sea revenue by 30 percent. The resulting gain to the post-independence UK is £1.5 billion.
- *Prices and production:* Hydrocarbon prices and production are lower than envisaged under the baseline scenario. As a result, the UK loses less North Sea revenue when Scotland leaves than the baseline assumes. To allow for this, we adjust the UK fiscal balance by +£1.3 billion.

Under this scenario, the UK net fiscal balance improves by £5.6 billion or 0.3 percent of GDP following Scottish independence.

There is also an intermediate scenario in which Scotland accepts responsibility for its per capita share of the UK national debt, but North Sea revenue remains buoyant because of high hydrocarbon prices and the Orkneys and Shetlands remain in the Scottish fold. In this scenario, the departure of Scotland has virtually no impact on the UK fiscal balance. This is probably the most realistic scenario.

The above scenarios indicate how little effect Scotland's departure has on the UK fiscal balance as a proportion of GDP. Even in the worst case scenario, the net impact on the UK fiscal balance is only -0.3 percent of GDP. Under the best case scenario the gain is 0.3 percent of GDP. The gain in the latter case would be somewhat larger, were it not for the fact that the UK continues spending almost as much on defence and other central government services as it did before Scotland's departure. From a UK fiscal point of view, Scottish independence is almost a non-event. This is not necessarily the case for Scotland, where under certain conditions the country is left with a fiscal deficit which is large in relation to its small economy.

Concluding Remarks

In projecting what would happen to government finances in the event of Scottish independence, the greatest area of uncertainty is North Sea revenue. In the case of North Sea revenue, there might be scope for some haggling over the precise boundaries of Scotland's exclusive economic zone, but these would be largely determined by established principles of international law. The main geographical uncertainty concerns the Orkneys and Shetlands which might opt to remain in the UK in the event of an overall 'yes' vote for Scottish independence. There is also uncertainty about the future behaviour of oil and gas prices. They are currently at a high level but could rise still further in response to world economic and political events. Or they could fall sharply as they did in late 2008, although this seems unlikely. A durable reduction in oil and gas prices would accelerate the decline in

North Sea hydrocarbon production, thereby reinforcing the decline in revenue from this source. There is also some uncertainty about debt and interest payments. Given its importance to an independent Scotland, it would be rational for the nationalists to seek to minimise their country's responsibility for the UK national debt.

The direct fiscal impact of Scotland's departure on the rest of the UK would be small in relation to UK GDP. There are also dynamic effects to consider. In the worst case scenario, an independent Scotland might find itself burdened with debt, with a large fiscal deficit and compelled to implement another round of austerity in addition to the period of austerity already experienced within the UK. This would damage economic growth in Scotland and have knock-on effects on the rest of the UK. In extremis, the UK might have to step in to help bail out Scotland just as it is currently helping to bail out Ireland. At the other extreme, given buoyant revenue from the North Sea, or perhaps some relief from its potential debt and interest burden, Scotland's fiscal deficit would be manageable and the country would not require external support. A prosperous Scotland would be a valuable trading partner for the rest of the UK, although it would also be a competitor.

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Final Version | May 2012

ICAEW—Written evidence

Introductory Comments

ICAEW welcomes the opportunity to comment on this important and wide-ranging Select Committee inquiry.

Independence in Scotland is ultimately a political question on issues of national identity and future, and as such will be decided by the Scottish people. ICAEW is an apolitical organisation so this response focuses on possible economic implications and the technical challenges a separation of Scotland from the rest of the UK would create. These implications and challenges are not insurmountable but, as a professional organisation for accountants, ICAEW would like to see costs quantified and complexities simplified as much as possible. Independence in itself does not affect the stock of labour and capital in either Scotland or the rest of the UK, and to that extent would not be expected to make a significant immediate economic difference. The overall fiscal stance might not be much affected by independence although the ability to alter tax rates could change the situation. In our response we outline some issues around altering tax rates in a newly independent Scotland. In principle – although there are practical challenges – Scotland could adopt its own currency and monetary policy.

It is important to frame this debate in light of the current Eurozone crisis. There has been a sense that Scotland could leave the UK because it would remain in the wider union of the EU. However the future of the EU – and crucially the single market – has become less clear with no obvious resolution in sight.

11 June 2012

SUMMARY

The issue of dividing assets and liabilities is complex, especially having to divide institutions and processes. With public sector employment in Scotland higher than the UK average this may make it more complex. We suggest a GDP based approach, and call on the ONS to produce pro forma national and government accounts for Scotland and the rest of the UK.

Paragraphs 7-13

These complex questions about division must address benefits entitlement with reference to current or previous residency/domicile. The issue of joint public services is key.

Paragraphs 14, 15

The experience of the independence of Ireland highlight the risks for Scotland in retaining sterling if the country has no influence on Bank of England monetary policy. We point out that Scotland already has three banknote issuers.

Paragraphs 16-18

There is a need to explore robust and tested financial arrangements and regulatory regimes prior to separation. We consider the role of the three UK-based banking groups registered in Scotland and the difficulties in securing lender of last resort facilities. Constraints are likely to come from both EU and global regulation. Solvency support for banking must also be

considered.

Paragraphs 19-23

Adopting the Euro would incur separation and transitional costs and create ‘winners’ and ‘losers’ when trading with Europe and the rest of the UK respectively. We are doubtful that Scotland would adopt the Euro given current conditions but may have to, making it difficult to then adopt any new Scottish currency.

Paragraphs 24-27

It would be difficult but feasible for Scotland to have its own currency. We cite examples of Lithuania, Latvia and Ireland.

Paragraphs 28-31

There is a lack of clear information on the current tax take in Scotland. Main concerns are around costs and complexity; taxing rights and double taxation issues.

Paragraphs 32-35

The impact of different tax rates raises issues of complexity and administration/collection costs. We mention the taxpayers’ actions to minimise tax and the danger of creating a ‘race to the bottom’, especially with regard to corporation tax.

Paragraphs 36-43

Lessons should be learnt from the current European debt crisis. Robust fiscal rules must be developed and enforced. Cross-border migration should be considered.

Paragraphs 44-49

There could be a divergence in the economies of an independent Scotland and the rest of the UK, and non-tariff trade barriers could emerge.

Paragraphs 50,51

Our recent research shows no early indications that independence would affect UK business. 75% of respondents with sites in Scotland felt it important to stay. We consider headquartering decisions and financial regulation.

Paragraphs 52-56

While Scotland is likely to be subject to the same economic challenges of the UK, ICAEW’s business confidence research shows Scotland can recover from shocks relatively quickly.

Paragraphs 57-59

Lessons should be learnt from the current Eurozone crisis. We emphasise the need for a robust risk analysis and suggest examining the independence of Ireland and others in order to draw valuable lessons for separation.

Paragraphs 60-61

Other issues have been raised by ICAEW members, principally the effects of uncertainty on the economy and around university funding in Scotland.

Paragraphs 62-67

Two appendices are attached: The ICAEW ten tenets for a better tax system and a summary of recent research on the potential effects of Scottish independence on our members.

ABOUT ICAEW

1. ICAEW is an international body based in the UK and operates under a Royal Charter, working in the public interest. The regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council.
2. As a world-leading professional accountancy body, the ICAEW provides leadership and practical support to over 138,000 members in more than 160 countries. Strengthened by the expertise of our whole membership, particularly those in the UK/EU who are interacting with government and institutions on similar economic issues, ICAEW is

working with governments, regulators and industry in order to ensure the highest standards are maintained.

3. We believe in acting responsibly, in the best interests of our members and the general public. We act with integrity, creating effective partnerships with organisations and communities worldwide to ensure the highest technical, professional and ethical standards.
4. ICAEW is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
5. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.
6. ICAEW Scotland serves over 1400 ICAEW members across the private and public sectors in Scotland and represents the views of ICAEW members who work in Scotland for local, national and international organisations.

Division of the UK's public assets, liabilities and expenditure

How should the UK's public assets and liabilities, from national debt and reserves to public pensions, North Sea oil and bank exposures be divided if Scotland becomes independent?

7. The division of assets will be subject to detailed negotiations by respective administrations. It will raise complex and contentious questions as each party will seek to obtain the best terms possible. The areas highlighted above are likely to be contentious and reaching an agreement that is satisfactory to both sides will require patient negotiation and a willingness for compromise.
8. While it may be straightforward to value and divide assets, this is not the end of the story. It is also necessary to divide institutions and their processes. This might mean creating new processes and IT systems. For example, how would HMRC be divided and how would it liaise with the revenue in Scotland? Currently HMRC offices and processes are not currently divided in any geographical sense. Would it be possible to separate Scottish taxpayers from existing computer systems and processes?
9. Proportionately more public sector activity is based in Scotland – partly due to UK government policy of locating public sector jobs in Scotland. Government statistics suggest the percentage of public sector workers to population is nearly 10% in Scotland as against 8.4% in the rest of the UK, meaning much higher relative costs for Scotland. If the ratio reduces and there are redundancies in the public sector before private sector investment could create more jobs, there could be additional transitional costs.
10. What transitional period would be needed and who would bear the conversion costs? The fragmentation of services is likely to increase costs and overheads for all, but the effect is likely to be proportionately greater in Scotland. However, this problem may be offset by how assets such as North Sea oil are divided. North Sea oil assets will need to take account of the impact of exploration and decommissioning costs and future tax revenues.

11. In 2010-11, the estimated current budget balance for the public sector in Scotland was a deficit of £14.3 billion (12.0 per cent of GDP) excluding North Sea revenue, a deficit of £13.6 billion (11.2 per cent of GDP) including a per capita share of North Sea revenue or a deficit of £6.4 billion (4.4 per cent of GDP) including an illustrative geographical share of North Sea revenue. In 2010-11, the UK as a whole ran a current budget deficit, including 100 per cent of North Sea revenue, of £97.8 billion (6.6 per cent of GDP). (source: GERS, Scottish Government, 7 March 2012).
12. While allocation could become highly complex, with different rules for different assets and liabilities, there would be merit in a simple approach that was, for example, related to shares of UK GDP.
13. ***As a starting point, ICAEW calls on the ONS to produce a pro forma set of both national accounts and government accounts for Scotland and the rest of the UK, with assumptions in these accounts made clear. This data is most likely already collected by the ONS.***

How would the UK's joint public expenditure flows, including social security, the Barnett formula transfers and defence spending be affected by Scottish independence?

14. These will be impacted by the policy decisions and negotiations around independence. Deliberations on social security spending, including state pensions, will need to address the entitlement to these benefits with reference to current or previous residency or domicile. The Barnett formula, which is to do with fiscal flows within the UK, would fall away.
15. Another issue is whether any public services would be delivered jointly between the rest of the UK and Scotland and how the costs would be divided – the obvious example being defence.

Currency, monetary policy and central banking

What are the implications of Scottish independence for the operation of the Bank of England? If sterling continues to be used in Scotland, would the Bank of England be required to take into account Scotland's economic conditions in setting monetary policy?

16. The experience of the independence of Ireland is instructive. Much will depend on whether Scotland keeps sterling at the time of independence. Ireland retained the link with sterling and it was not until 1978 that it established a completely independent currency. If Scotland retained sterling, it would be a proportionately larger part of the sterling area than Ireland was in the period from 1922 to 1978. Thus, the potential impact on the rest of the UK if Scotland retained sterling would be far greater. The rest of the UK might therefore insist that Scotland has to change its currency, though may be unable to compel it to change, (c.f. Montenegro and Kosovo unilaterally adopting the euro).
17. From Scotland's point of view, there are major risks inherent in retaining sterling if Scotland is unable to influence the Bank of England's monetary policy. This is clearly a matter for negotiation, but Scotland's position would appear to be extremely unsatisfactory if it retains sterling but has no say in the Bank's monetary policy. It is

worth noting that central bank effectiveness partly depends on the clear backing of a 'parent' sovereign, and it would not be easy for the Bank of England to serve two countries.

18. However, it should be borne in mind that Scotland already has three banknote issuers, which are required to back these notes fully with Bank of England notes. That could form the basis for a Scottish pound (and would be what economists call a 'currency board'). However, there would be no Scottish influence over Bank of England monetary policy – but realistically the influence is limited even now because Scotland is a relatively small part of the total UK economy.

What would be the implications for the stability of the UK's financial system, and the financial system of Scotland, of Scotland becoming independent and retaining sterling as its currency? Would a Scottish monetary authority offer lender of last resort facilities and how would financial institutions respond? What would be the implications of possibly different regulatory regimes in an independent Scotland and rest of the UK?

19. Experience of the current problems in the euro zone demonstrate that proper and lasting arrangements need to be designed and 'stress tested' against a variety of financial situations. Design mistakes may not be apparent until much later, at which time the financial and economic consequences could be serious.
20. Currently, three UK based banking groups (Clydesdale Bank, Lloyds Banking Group and Royal Bank of Scotland) are registered in Scotland but the majority of their business is elsewhere in the UK. The separation of financial stability mechanisms, including the Financial Services Compensation Scheme and regulatory regimes is likely to influence their future organizational structures.
21. It would be difficult to offer lender of last resort facilities to the extent that the Bank of England would not be Scotland's central bank. However, where appropriate such operations are indemnified by the sovereign (HM Treasury at present), so the Bank of England might be willing to act on the basis of a Scottish government guarantee.
22. The scope for Scotland to operate a different regulatory regime would be constrained by the extent to which these arrangements are harmonised globally and especially in the EU.
23. Solvency, as opposed to liquidity support, must also be considered. The Scottish economy may not be large enough to take on the contingent liabilities associated with the Royal Bank of Scotland and Lloyds Banking Group. It may be possible to split off some or all of RBS's 'non-Scottish' business into an English domiciled entity. This could probably be achieved without legislation as the UK Government owns most of the economic interest in RBS.
24. **What would be the implications for Scotland and the rest of the UK if an independent Scotland switched to the euro?**
25. If Scotland adopted the euro, it would have important consequences for Scotland and the rest of the UK that would need to be managed in the short-term. It would create further separation and transitional costs. Given the two countries would remain closely linked, currency problems in either country would inevitably have some impact on the other.
26. The additional costs for businesses operating both in Scotland and in the rest of the UK would be significant: with a variety of 'foreign exchange' issues arising on a day-to-day basis and requiring significant administrative input.

27. Conversely, the many Scottish-based businesses trading predominantly with euro zone countries could be expected to benefit from cost savings to an equal extent: so there would be both ‘winners’ and ‘losers’ over this issue.
28. Ultimately, in present circumstances it seems doubtful that Scotland would adopt the Euro. However, analysis by Business for New Europe of the EU Treaty legalities around Scotland remaining in/joining the EU are such that it would at least notionally have to commit to joining the Euro. The practical significance is that it would be difficult for Scotland to adopt a completely new currency.

Could an independent Scotland have its own national currency? What would be the practical consequences if it did?

29. There are several reasons (one noted above) why it would be difficult for Scotland to have its own national currency.
30. The experience of Ireland breaking from the link to sterling from 1978 onwards would suggest that it would be feasible for Scotland to have its own currency so that development should be studied in detail. However, world economic and financial situations have changed considerably in the intervening 34 years and the present day dependence on IT based financial systems will result in significant sterling separation and conversion costs.
31. The costs for businesses operating both in Scotland and in the rest of the UK would again be significant, as noted above, but without any savings for Scottish businesses trading with Eurozone countries.
32. Eurozone members Lithuania and Latvia, which are smaller economically than Scotland, have their own currencies – but such currencies in practice are not widely convertible internationally. A separate Scottish currency would impede cross-border trade with the rest of the UK to some degree – though this has not been insurmountable between Eire and Northern Ireland, for example.

Fiscal policy and taxation

What would be the fiscal consequences for other parts of the UK of an independent Scotland?

33. This is a critically important question for both an independent Scotland and the other parts of the UK, the answer to which requires accurate data. However, according to the paper “Devolving Corporation Tax in the Scotland Bill” prepared by the Scottish Government in September 2011: *“There are no separately collected figures on the amount of corporation tax raised in Scotland. Figures compiled by HMRC are not disaggregated below the UK level.”* Lack of information on the current tax take in Scotland would be a shaky foundation on which to base projections of future tax revenues north and south of the border. Similarly, can current expenditure on state pensions and benefits be accurately split between Scotland and the rest of the UK? In the absence of detailed information estimates can be made, but they would only be as good as the underlying data and assumptions.
34. Likely concerns surrounding fiscal independence would include the additional costs and complexity that would be incurred. The main issues would be around cross-border trading and the incidence of double taxation. This has not been an issue to date, although may become so after Scotland is able to set its own tax rates. It will be necessary to

decide on taxing rights, for example for income tax by reference to residence and domicile of individuals and for companies by where they are incorporated or managed and controlled. Other taxes might be based on where assets are physically located.

35. The UK currently has in excess of one hundred Double Taxation Conventions with overseas taxing jurisdictions. These have been individually negotiated to avoid double taxation by allocating taxing rights and to provide mechanisms for resolving disputes. It seems likely that an independent Scotland with its own tax system could no longer be a party to these Conventions and would need to establish their own.
36. In order to minimise possible problems of double taxation in the UK, it would be necessary for Scotland and the rest of the UK to enter into a comprehensive double taxation agreements in line with international practice. The key issue would be clarity: it would be essential for both countries' taxing rights to be clearly understood by Government, the tax authorities, businesses and individuals.

What would be the effects on other parts of the UK and on Scotland of an independent Scotland introducing different tax rates? How would businesses and households respond? What are the implications for the UK's and an independent Scotland's tax base?

37. Existing Scotland Act provisions have already created a framework for differential tax rates between Scotland and the rest of the UK from 2016 onwards. Our principal concern is that such differential tax rates may create serious, expensive, complicated and unintended consequences for both Scotland and the rest of the UK. Given these issues already exist, an independent Scotland might be better placed to avoid such unintended consequences through a more flexible and adaptable approach to fiscal policy than that permitted under the Act.
38. ICAEW's Tax Faculty has developed Ten Tenets for a Better Tax System: details are attached as an appendix. Our core principles are that tax should be certain, simple, and easy to collect and calculate. We advocate simplicity in tax systems as a basic core element to aid understanding, compliance and avoid unnecessary costs.
39. When measured against these principles, we are concerned about more complexity within the UK infrastructure and this raises questions about how tax would be collected and administered in an independent Scotland as well as the quantification of the transitional and ongoing costs of collection from a smaller taxable population. These complexities need to be mitigated on both sides of the border. We note the Scottish Government's plans to establish Revenue Scotland by 2015 to collect devolved taxes.
40. Different tax rates will inevitably result in taxpayers seeking to ensure they minimise taxes where possible. The extent of this will depend upon a number of factors, not just the actual difference in rates, but also the compliance costs and the ease of moving (for example residence status) between the two countries. For SMEs it is only likely to be a problem in the areas closest to the border, e.g. the north of North of England and the Scottish Borders, for businesses that currently trade cross border.
41. However, most large UK companies will have operations on both sides of the border and considerable additional administration costs will be incurred in keeping separate accounting records so that trading profits and losses can be allocated to Scotland and the rest of the UK in accordance with the double tax treaty referred to above. Note that

such costs will be incurred even if the rates are the same on both sides of the border but if different rates apply there will be an incentive to reduce the overall tax burden by either adopting favourable transfer pricing policies or else moving activities from one country to another. If businesses are moved to take advantage of lower tax rates then this could have considerable impact on employment.

42. With differing tax rates, Scotland and the rest of the UK will inevitably become competitors at an international level, with both countries seeking to attract businesses and skilled individuals through the manipulation of fiscal policy. Such competition could be healthy and could benefit either or both countries. On the other hand, there is a risk that a 'race to the bottom' for the lowest tax rates could damage both countries and produce no long-term benefit for either.
43. In this context, ICAEW would like to see some form of mechanism in place for mutual co-operation between the two former parts of the UK designed to ensure that future fiscal policy is implemented responsibly and does not lead to a mutually detrimental outcome through low tax rates alone.
44. From a Scottish perspective, independence would provide the opportunity for a more flexible approach to design a Scottish tax system tailored to the specific requirements of individuals living and businesses operating in Scotland. This would enable Scottish tax rates, allowances and reliefs to be better targeted at the needs of businesses operating in Scotland, providing the means to boost the Scottish economy without resorting to a mere crude manipulation of tax rates.

What would be the impact on the rest of the UK's debt if an independent Scotland issuing debt were to face a sovereign debt crisis? Would the spill-over between the rest of the UK and an independent Scotland require fiscal rules to limit risk exposure? Would they work?

45. Lessons should be learnt from the current debt crisis in Europe. Fiscal rules to limit risk exposure would appear to be necessary and agreements would need to be put in place at the outset for the sharing of risk around flexibility in national economies.
46. The UK as a whole needs to be clear about risks and exposures at the beginning of any process of UK break-up. The old saying 'good neighbours build high fences' might well apply.
47. Potential cross-border migration stimulated by a sovereign debt crisis would also be a risk to be considered early in the process.
48. The over-riding need will be to build a robust framework of fiscal rules to survive future shocks and minimise risks. For example, there are questions about whether Scotland would keep sterling or adopt another currency. However, this question also needs to be looked at from the other end of the telescope. Given the lessons to be learned from the economic and financial turmoil in the Eurozone, the rest of the UK would look to reduce potential risks of a Scottish sovereign debt crisis. The rest of the UK might therefore insist that, as part of the price for independence, Scotland either accepts some oversight of its fiscal plans or else it must adopt another currency. Conversely, Scotland's financial and economic future would be closely bound up with, and largely governed by, the economic and financial position of the rest of the UK over which it had little or no control.

49. If Scotland suffered a sovereign debt crisis the impact on the rest of the UK would broadly be the same whatever currency Scotland adopted. The impact would reflect the loss of trade and other economic factors arising, including any moral obligation on the rest of the UK to contribute to assisting Scotland (ie similar to the UK contribution to the Irish bail-out).
50. The issue of sovereign debt sustainability is important as markets are not entirely rational and – partly for historic reasons – are relatively tolerant of sometimes high UK public deficits and public debt levels. It is not obvious that this would extend to the debt of a newly independent Scotland.

Economic structures, cycles and flexibility

Would the economies of the rest of the UK and an independent Scotland be likely to diverge or remain similar? If diverge, how would this affect the rest of the UK? Would economic cycles converge or diverge and what would be the consequences?

51. Based on experience following the independence of Ireland, it is likely that the two economies will naturally diverge, but given the on-going close connections it seems likely that the economic cycles will have some correlation. Indeed, it could be argued that the purpose of independence would presumably be for Scotland to diverge socially and economically from the rest of the UK. However, to what extent that might be and how it might vary in the economic cycle we do not know and much will depend upon the economic and fiscal policies adopted by each country afterwards.

Would independence for Scotland affect its trade / current account balance with the rest of the UK? What would be the consequences? Could non-tariff trade barriers emerge over time?

52. These questions are largely outside our area of expertise. As for non-tariff trade barriers, the position would depend to some extent on whether Scotland and the rest of the UK remain part of the EU and are therefore bound by the EU treaty freedoms that prohibit discrimination. It is possible that non-tariff trade barriers could emerge in time, for example regulatory requirements might diverge and become more onerous in one country, thereby creating a barrier of sorts.

Would there be more movement of large company/financial institution headquarters from/to an independent Scotland and the rest of the UK? Would Scottish independence have any impact on labour markets across the UK?

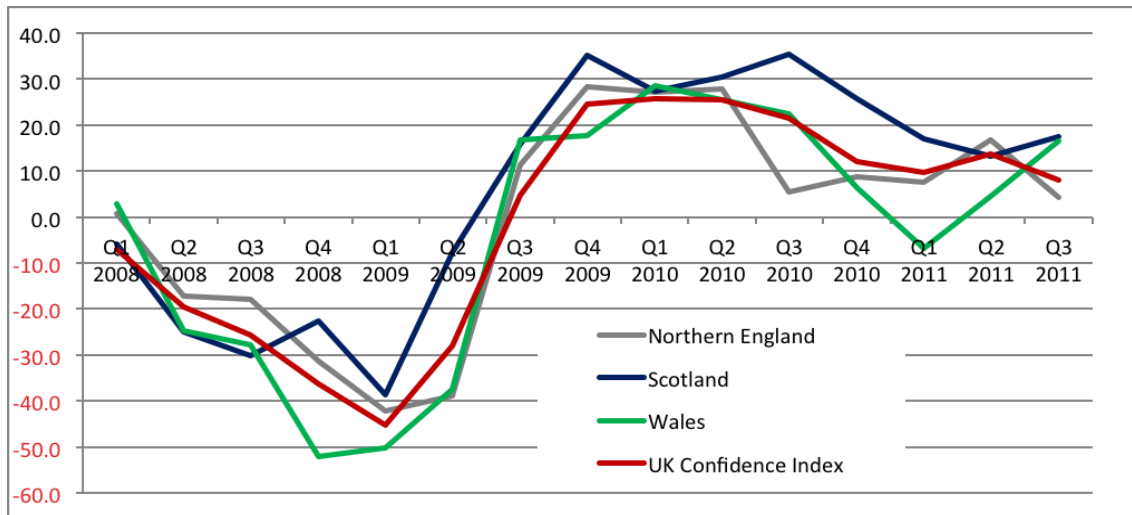
53. Our most recent research (see Appendix II) on the potential effects on business of an independent Scotland shows no early indications that independence would affect UK businesses. However, three quarters of those asked with sites in Scotland think it important to keep their presence in the country for a range of reasons including brand credibility/history and the availability of local specialised skills (especially in oil and mining).
54. A range of factors affects multi-national organisations' decisions about where to base their headquarters. In general terms, these factors will include political and economic

stability, a convenient location, currency, language, corporation tax rates and investment allowances and incentives, good infrastructure, and an accessible and educated labour force (as mentioned above). They will also value a cost-effective and efficient regulatory structure that is simple and certain and which enables them to plan and invest for the longer term.

55. Given the range of factors and no prior knowledge of what policies would be pursued by a Scottish Government, we cannot comment on whether an independent Scotland would, per se, be more or less attractive for large companies. However, it is inevitable that competition for foreign business and investment would become more overt.
56. In a previous consultation paper on corporation tax in Scotland, ICAEW Scotland discussed the dangers of focusing purely on a potential reduction in corporation tax rates as a way of attracting companies to the country (thus creating the potential ‘race to the bottom’ discussed above); while ICAEW Tax Faculty responded to the HM Treasury consultation document *Rebalancing the Northern Ireland Economy*. In our earlier response we set out some key issues including the need for simplicity, the implications of having more than one corporation tax system in the UK, the need for a detailed cost benefit analysis, and the implications for HMRC, as well as looking at alternative mechanisms and policy options that might work in Northern Ireland. The Committee may find it useful to read our previous documents, which are available on request.
57. No consideration appears to have yet been given to how Scottish Financial institutions would be regulated. Given this is a significant proportion of the Scottish economy, decisions would need to be taken well in advance of a referendum. Would the FSA (or successor organisations) – currently a UK organisation - remain as supervisor, or if a new regulator is to be established, how would it be funded, organised and would new rules be required? London is not a cheap and easy place to do business, yet it remains the primary financial centre in Europe. One reason for this is the strength of regulation. If Scotland were to start from scratch in terms of regulation, how long would it take to gain the trust of the business world?

What would be the impact on other parts of the UK if an independent Scotland were not flexible enough to respond to an economic shock? Does the rest of the UK adjust more or less rapidly to shocks than Scotland?

58. If Scotland kept sterling, the rest of the UK would be likely to require robust fiscal rules on risk exposure from the beginning of any new constitutional arrangements. Given current experience of the problems in the euro zone and its impact on the UK, it seems likely that an independent Scotland would be extremely vulnerable to economic problems in the UK, given that the rest of the UK is currently and will probably continue to be its largest trading partner, whereas the rest of the UK is likely to be less vulnerable if economic problems were confined to Scotland – especially if Scotland adopted a different currency.
59. Regarding the question of whether the rest of the UK adjusts more or less rapidly to shocks than Scotland, ICAEW can offer an insight from on-going research undertaken among ICAEW members in business throughout the UK, as follows:



ICAEW/Grant Thornton Business Confidence Monitor results Q1 2008 to Q3 2011

60. It is interesting to note the speed with which business confidence among Scottish businesses bounced back after the banking crisis that was so keenly felt in Scotland. The chart below picks out the confidence index for Scotland compared to the UK average. In 8 of the 10 quarters from Q4 2008 to Q1 2011, Scotland was the most confident geographical area of the UK. The implication is that Scotland has the capability to bounce back from large shocks, certainly carrying strong levels of confidence compared to the other country with devolved powers (Wales). However one must acknowledge that the banking crisis, while impacting on the Scotland ‘brand’, was then managed by the UK government and the Bank of England.

Lessons from other countries

Are there lessons from the experience of previous separations, such as Irish independence in 1922 and the break-up of Czechoslovakia in 1992, or where separation has been advocated, as in Spain and Canada?

61. In answering this question, we would point to current problems being experienced in the Eurozone, especially with Greece. In the light of this experience, a robust risk analysis would be required and steps taken to minimise them, bearing in mind that the risk may not be apparent until many years later, by which time the extent of the problems could have reached serious levels.

62. Evidence of partitions elsewhere may identify potential problem areas and how they were resolved. There should be a detailed study of the independence of Ireland and what lessons can be learned. Much would also depend upon what currency Scotland adopts. Further, the precise set of circumstances may be different – for example, Ireland stayed pegged to sterling for over 50 years after independence. More recent examples of partition include the Soviet Union, Czechoslovakia and Yugoslavia. All of these were undertaken in different circumstances but it may be possible to draw some useful lessons.

Other Comments

We would like take this opportunity to highlight some other comments and concerns received from our members in response to this consultation, which do not necessarily fit under the specific questions asked by the committee.

The effect of uncertainty

63. As many questions as possible should be explored in advance of a referendum, especially on apportionment of costs and income.
64. Whatever the outcome of the referendum, the uncertainty is likely to be a challenge, as well as an opportunity for business in Scotland. Potential and existing customers and partners will need to be reassured throughout the process.
65. Scenario planning on strategies should be encouraged by companies currently domiciled in Scotland. Key decisions would include where to locate head offices and this would impact on both the UK and Scottish Governments.
66. Evidence suggests that independence discussions are already creating uncertainty with businesses deferring or adjusting plans until certainty is secured. One example is the Feed-In tariff payments regime. One bank manager suggested that unless the loan could be repaid by 2016 they would not lend as they had no certainty the payments would be made by an (independent) Scottish Government.

Universities

67. Scottish Universities receive some £200m for research from the UK Research Councils. They also host major UK wide research facilities, e.g. the UK high Performance Computing facility hosted by the University of Edinburgh. Independence will raise questions about this and similar programmes. If this funding is lost and not replaced, research capacity in Scottish Universities will contract limiting the ability to attract leading researchers.
68. Independence will also change the status of English and Welsh students to those of EU students. This could result in reduced funding into undergraduate teaching in Scottish Universities and a possible reduction in numbers. The current Government estimate of fees from these students of more than £60m a year could be lost.

APPENDIX I

ICAEW TAX FACULTY

THE TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain.

It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

APPENDIX II

Early attitudes to effects on businesses of “yes” vote in Scotland

Background

The Scottish referendum on whether to leave the UK is planned for autumn 2014, and the “Yes” campaign (pro-independence) was launched on 25 May 2012. In April/May 2012, ICAEW took a temperature check of early business sentiment among senior decision makers in 410 UK businesses with customers, suppliers or operations in Scotland. We looked at perceived impact on businesses of Scottish independence, or Scotland remaining in the UK but with greater control over its taxes and regulations (Devo Plus).

No early indications that independence would affect UK businesses

At this time (April/May 2012), 76% across the UK foresee no overall impact on their business of independence, with similar responses for Devo Plus (70%). This is largely because

Scotland accounts for relatively little of their turnover, and/or they have the view that an independent Scotland would become just another export market.

Interestingly though, three quarters of those with sites in Scotland think it important to keep that physical presence. They cite a range of reasons;

- having invested in buildings there,
- brand credibility/history,
- the need to be physically close to customers, and
- some oil/mining companies have to be there, and they benefit from local availability of skills in their sector.

End.

ICAS—Written evidence

- 1) The Institute of Chartered Accountants of Scotland (“ICAS”) is the professional body of accountants. We represent around 19,000 members who advise and lead businesses. Around half our members are based in Scotland, the other half work in the rest of the UK and in almost 100 countries around the world. Nearly two thirds of our members work in business, whilst a third work in accountancy practices. ICAS members play leading roles in around 80% of FTSE 100 companies. ICAS is also a public interest body; we do not take a political stance and will not take a stand for or against any Scottish independence referendum proposal.

Fiscal policy and taxation

- 2) ICAS welcomes the opportunity to contribute to discussions on the issues arising from Scottish independence. In this submission we address Questions 3a and 3b, Fiscal policy and taxation.

Question 3 a

- 3) It may be obvious, but a point worth emphasising at the outset is that the debate on the impact on Scotland, as well as other parts of the UK, of an independent Scotland with a separate tax base is in danger of being conducted in a void. At this stage, there are no proposals for what might be the tax system of an independent Scotland, albeit a consultation has just been announced on proposals on the replacement for stamp duty land tax devolved by the Scotland Act 2012. Without progress on the design of any tax system for an independent Scotland, it is not possible to reach any conclusion on the impact of such a system for any part of the UK. The main conclusion that can be reached at this stage is that uncertainty results from the lack of tax system proposals to assess this impact, and that work is required to address this uncertainty, following which an informed debate would be valuable.
- 4) In order to stimulate consideration of the issue of tax in an independent Scotland, or in any further tax devolution, and indeed to highlight the complexity of the issues in designing a tax system, ICAS recently initiated a members debate based on a thought leadership paper “Scotland’s Tax Future; What Tax System Would Scotland Want?”, the text of which is attached at Appendix I. This paper will inform future contributions by ICAS to the debate on Scottish independence and/or further tax devolution and is expected to provide evidence for future inquiries.
- 5) In the absence of proposals for a tax system for an independent Scotland, consideration of its impact has to be based on a set of assumptions. There is a crucial caveat: - there has to be a clear understanding of what those assumptions cover and how such assumptions might affect consideration of the questions posed. The tax system of any

country is made up of a cohesive set of rules, which define who pays tax and on what they pay tax (the tax base), the operation of any reliefs, relationships with other tax jurisdictions, compliance obligations and penalties for failure or evasion. Administrative machinery is essential, possibly including deduction at source and tax collection mechanisms. Tax rates are the final element, but they are only one element of the impact of an overall tax system on an economy and the individuals and businesses living and operating within that economy. Assumptions must be made for each of these aspects for an independent Scotland to answer the questions posed.

Question 3 b

- 6) To address the question as regards tax rates, it needs to be remembered that there are a number of UK tax rates, any one or more of which might be assumed to be varied, in any combination, under any independent Scottish tax system. The Finance Bill 2012 provides that UK companies will pay corporation tax this year at 24%, or 20% where profits are low (30% or 19% for ring fence profits), but at a marginal rate of 25% where profits exceed the low profits limit. Individuals may pay income tax in the tax year 2012/13 at 0%, 10%, 20%, 32.5%, 40%, 42.5%, 50% or 62.5% (where personal allowances are clawed back), and these rates can vary annually. Individuals may pay capital gains tax in 2012/13 at 0%, 10%, 18% or 28%. The Scotland Act 2012 allows only variation of some of these rates; those at 20%, 40% and 50% and only on non-savings income. As regards consumption taxes, VAT rates may be levied or varied, depending on the membership status of an independent Scotland within the EU, and operate currently at 0%, 5% and 20%. Excise duties on alcoholic drinks may change. Property taxes levied as business rates or on the sale of property, such as stamp duty land tax, are also to be considered but, as devolved (or devolving) taxes are already under consideration by the Scottish Parliament. When revenue generation from tax is to be maintained, any cut in rates in one area is likely to be balanced by an increase in rates in another, by the same government. In view of the point made above at paragraph 5, regarding the need to understand the assumptions in the design of the overall tax system, the impact of any variation of tax rates in Scotland in practice is likely to involve more complex analysis than a simple “higher or lower” approach adopted in some discussions. The comments below are in this context.

Individual impacts

- 7) The general observation could be made that most people do not like paying tax and, given a legal and legitimate choice, are likely to opt to pay less tax rather than more. Attempts to pay tax at lower rather than higher personal tax rates within the UK - capital gains are taxed at lower rates than income, for example - have resulted in a considerable amount of anti-avoidance legislation within the UK tax system. Likewise, there are extensive provisions in the UK tax legislation to prevent tax leakage from the UK tax net to overseas tax jurisdictions, particularly low taxed areas. The individual

behavioural approaches and responses to the tax environment would reasonably be assumed to continue should tax rates differ between different parts of the UK, which may require additional legislative provisions, depending on the policy response taken.

- 8) One key issue to be addressed by the UK government would be whether any independent Scotland would be simply another non UK, overseas tax jurisdiction as regards the rest of the UK, or any “special relationship” view would be taken. From a tax technical perspective, the question would be whether Scotland would become non-UK for these purposes or whether the current UK anti-avoidance provisions for transactions or individuals in non-UK regimes might be in some way, relaxed. Policy and administrative effort is likely to be needed to identify whether, and what, double tax treaty between Scotland and the rest of the UK tax system might be needed, and the terms of the treaty. Future consideration would need to be given to whether that debate would be part of any potential future independence settlement or would follow thereafter. In summary, not only is a Scottish tax system design needed, in order to determine the impact of independence on all UK taxpayers, but the rest of the UK tax system consequences also require policy design decisions and responses to be formulated.
- 9) It may be worthwhile to consider a practical example. Take an individual taxpayer living in London and with savings in a postal/internet bank account at a high street retail bank based in Edinburgh.

When that Scottish based financial institution pays interest on the savings the interest might be paid net of a Scottish basic rate income tax (again, depending on the independent Scottish tax system) similar to the UK income tax withheld at present at 20%. That Scottish tax might become “foreign” tax for the purposes of determining a UK tax liability, although current tax law would allow it to be offset against the UK tax liability on the same amount, that requires an additional tax return claim. Repayment of any excess Scottish tax deducted would be determined by the terms of that Scottish tax system and any double tax treaty between Scotland and the rest of the UK, or, alternatively, different legislative provisions may be enacted in both jurisdictions, applicable EU rules permitting. This also applies in the mirror scenario, where an individual living in Edinburgh had savings in a retail bank based in London. It might be that individuals would decide to keep their tax affairs simple by keeping funds within their domestic tax regime. Whether that would result in the movement of funds between institutions in different jurisdictions, or whether those jurisdictions adapted their international business structures to ease the position of the individual saver is a matter at present of pure conjecture. Until more of these uncertainties are addressed, we come again to the conclusion that it is not possible to assess the impact on individuals in this example situation. We can only begin to identify areas on which clarification would be helpful to a future analysis.

- 10)** The above example highlights that tax impacts rarely arise in isolation; an individual's decision on which savings account provider to save with is also likely to be determined by factors such as the currency and interest rate offered in that jurisdiction, any financial guarantee arrangements and the regulatory and control environment of the financial institution. Tax impacts are also linked to a country's welfare regime. Where there is high dependence on the state for support, there may be higher taxes levied to pay for that. Where there is greater dependence on private provision, taxes may be lower and savings incentivised through the tax system. Taxes rarely occur in isolation of the wider environment.

Business impacts

- 11)** Businesses conducted by individuals in the UK are within the income tax system. Businesses conducted in the UK by companies are within the corporation tax system, and it is these businesses that are considered in this part of this submission. The impact on businesses from a change in corporate tax rates is dependent, as described above, on the nature of the overall tax systems or assumptions made about it. If the key assumption were made, that independence affected only corporate tax rates, then the position is approaching that which ICAS commented on in relation to devolving corporation tax to Northern Ireland in its submission to HM Treasury in June 2011 "Rebalancing the Northern Ireland Economy". In that, ICAS expressed concern around the consequence to corporation tax law as it would affect the rest of the UK. The views expressed represented those of members of the Institute consulted in recent years over Scottish tax devolution issues, updated by those from several tax committees comprised of members with considerable experience on corporate and cross border business tax issues. It follows that the more changes to a tax system that arose through independence, the greater the scope for other impacts to arise.

It must be emphasised that the comments were made at the start of a debate on different and very specific proposals, and the debate is moving on to one where there is a need for more research, evidence or discussion tailored to the prevailing economic circumstances of Scotland and the UK. The main points from the June 2011 ICAS submission, relevant to this inquiry, are set out below.

- 12)** The concerns expressed in respect of devolving corporate tax powers to Northern Ireland were the same as those for Scotland, which were included in the final report from the Calman Commission published on 15 June 2009 as "Serving Scotland Better: Scotland and the United Kingdom in the 21st century (Final Report)". Specifically, the evidence provided in that report, is summarised below:

- 1) The potential for divergent rates of corporation tax across the UK to create economic inefficiencies as firms react to considerations other than commercial factors, and indeed harmful rather than efficient tax competition.

- 2) Evidence that a cut in Scottish corporation tax would attract more profit shifting behaviours than create real economic activity. This is an increasing issue in the electronic age and with video conferencing. The application of anti-avoidance provisions relating to profit shifting would have to be widened to deal with this, adding unwelcome administrative complexity for all UK businesses, not just those in the specific devolved jurisdiction.
 - 3) The potentially significant additional administrative burden and tax compliance costs for companies throughout the UK and HMRC from changes necessary to monitor profit-shifting through, for example, transfer pricing legislation. In particular the exemption currently enjoyed by many small and medium sized enterprises would need to be reconsidered if devolved corporation tax powers are to be effective in achieving their aims, given the predominate business profiles in each jurisdiction, even if the devolved corporation tax rates do not vary significantly from the main UK rate. Determining tax residence of companies, branches and permanent establishments would also create additional burdens.
 - 4) The case for substantive reduction in the possible rate of corporation tax for Scotland was considered to be limited in the short term if the level of public services were to be maintained, at least until or unless Scottish Parliament revenues could be raised from other sources. However, the risk if more than one jurisdiction within the UK has corporation tax varying powers, of a “race to the bottom” is likely to be counter-productive.
 - 5) A key driver to devolution of tax powers was the accountability of the Scottish Parliament; this was thought to be better achieved through devolving powers on taxes other than corporation tax, particularly those with a closer connection to the electorate.
 - 6) The volatility of corporation tax receipts on a localised basis rather than from the UK economy as a whole was a concern, given that European Union state aid rules do not permit any shortfall to be subsidised by the UK government in such circumstances.
- I3)** We saw, and see, no case for considering the Northern Ireland tax issues as sufficiently distinct from those of Scotland to reach a different conclusion, particularly around tax competition and complexity.
- I4)** There were other key aspects of tax policy making in the UK which were relevant considerations.
- 1) Firstly, the principle of aiming for stability and certainty in tax matters at a UK level

has been greatly welcomed as a means of making the UK as a whole more competitive on the international stage. Any devolution of corporation tax powers to different parts of the UK would reduce stability and certainty, so could reduce the attractiveness of the UK as a whole as well as the particular jurisdiction. This could make any changes counterproductive.

- 2) Simplification of the tax legislation and the practical operation of the UK's self-assessment regime have been called for consistently and we support the Government doing more in this area. Devolving corporation tax powers will require additional efforts from businesses and their advisers working across the UK achieves less, rather than more, simplification.
- 3) In considering the potential for a reduced corporation tax rate of 12.5% for Northern Ireland (or any rate materially lower than an income tax rate) the behavioural consequence of unincorporated businesses seeking to incorporate to take advantage of this rate needs to be considered, along with any evidence that it would stimulate economic activity on a standalone basis. The UK experience of the years 2000 to 2005 with a 10% and then 0% corporation tax rate gave a marked demonstration of this and resulted in an overall reduction in tax payable on those earnings; we have not seen any evidence that additional economic activity resulted from that approach, hence the lower rates were abolished in 2006.
- 4) Finally, evidence from members raises serious concerns as to the impact on HMRC resources, and whether HMRC would be able to cope with either the changes required or implementation of such devolved powers at any stage in the current spending round. We have expressed in the past concerns over delays and service levels at HMRC, which were also addressed by House of Commons Committee last year. Any additional resources required will have to be fully costed, should any devolved power be required to meet such costs. There may be both fixed costs, which will be presumably incurred up front, when the expected revenue generation will be undetermined, and variable costs of operating increased legislative burdens in, as suggested above, areas such as transfer pricing.

Appendix I – “Scotland’s Tax Future; What Tax System Would Scotland Want?”

Introduction

ICAS – the professional body of accountants – is in an interesting place when it comes to tax devolution.

By tax devolution we mean any form of control of taxes passing from Westminster to Holyrood, whether under the current Scotland Bill, emerging discussions on full fiscal independence, or anywhere in between. As probably the single largest body of financial and tax experts in Scotland, with members throughout the world, ICAS has the depth of

knowledge and experience to inform any debate over tax devolution, highlighting opportunities, pitfalls, administrative issues or behavioural responses. We have a wide range of overseas experiences and insights into the workings of the best, and less successful, practices. The principles are the same whichever part of the UK may seek or obtain tax powers, but when aligned to the political landscape, the Scottish example has particular salience. ICAS has a public interest remit, a duty to act not solely for its members but for the wider good. So it is in the enviable position of having both the key competencies and focus to inform, and, arguably, lead the debate on the most interesting question of 2012 – what tax system would Scotland want?

This paper is not written with a political perspective, or to address the single, narrow topic of what the rate of a particular tax should be; instead it approaches the issue from a much broader and more challenging perspective. It seeks to share ICAS insights into the many complex issues and decisions involved in tax system design, whether this design is driven by the necessity of raising revenue, the opportunity those new tax-raising powers might bring to deliver more innovative or better funding solutions, or a mixture of both. It seeks to broaden the discussion well beyond the debate on the current Scotland Bill provisions, which use as a basis the existing UK tax system and some limited tax varying powers. It also contributes the experience of decades of work which ICAS members and staff have undertaken, often without public profile, with the UK Government and its agencies on the shared agenda of a better-balanced outcome for all tax stakeholders. This paper also refers interested readers to recent relevant research work in this specialised field.

The UK tax system has many imperfections; the complexity that comes from over 200 years of accumulated drafting and tinkering; challenges regarding the fairness of the sharing of the tax burden, and difficulties with HMRC computer systems and administration. Although any transition to fiscal devolution would have to start from here, what exactly is the destination? What tax system would Scotland want? What tax system should any Government of Scotland propose to meet the required revenue-raising targets as well as wider key principles, such as fairness, high levels of acceptability and compliance, low costs of collection and ease of administration? How practical and cost-effective would any transition be from the current system? To take matters forward, this paper divides these topical and highly important issues into six key questions that need to be explored.

The aim of this paper is to develop these questions and stimulate debate amongst members. Whilst the debate cannot abandon the practicalities of any tax system change – which may limit, perhaps severely, any aspirations or wishes for change – nevertheless it is worthwhile focussing on what a tax system can and should achieve, to also inform the approach to those practicalities. Once members' insights have been gathered, the output and topics for debate will be shared more widely amongst interested parties. Members' comments are requested by the end of May 2012.

Key observations

Conclusions can be drawn on a way forward once the wider debate mentioned above has taken place. However, some observations are already worth making.

Firstly, the Scottish Government has at present neither an established mechanism, nor the expertise or resources to respond alone to these questions. The reservation of tax powers to Westminster means it has to be questioned whether the Scottish Government has the full understanding of the complexities of the operation of a tax system to enable it to opine authoritatively on this topic. It needs to address this gap urgently if any worthwhile progress is to be made to meet public expectations that it is making any credible attempts to move the tax devolution agenda forward in the optimum fashion. It would be helpful in the discussion regarding devolution (whenever and under whatever provisions that takes place) to know when and how these questions might be addressed. After all, raising revenue will be fundamental to the operation of any new constitutional arrangement, and the outcome of the debate could have a very direct and personal impact on every Scottish taxpayer. ICAS is happy to contribute the skills and expertise of its members to discussions to take this forward, and to suggest sources and analyses of interest and relevance.

Secondly, the complexity of tax systems around the world and their interaction, both structurally and operationally, is more than anyone would set out to design now. This complexity should not be underestimated. The current UK tax provisions are little understood or believed except by those who have spent their careers trying to navigate through the thousands of pages of legislation, guidance, forms and deadlines; a matter not to be taken as an expression of professional or intellectual arrogance, rather one of sad realisation based on sometimes painful practical experiences.

Thirdly, the general public are often dissatisfied and confused by their interactions with HMRC, and might vote for any change as a promise of improvement. But what is this change to be? You do have to start from here. As anyone who has looked at any isolated change to the tax system recently, such as the brief foray into the zero and 10% corporate tax rates in the past decade would know, the scope for getting any major change wrong is massive and can have serious consequences for tax yield. There is also much opportunity to learn from other regimes, existing expert studies and the talent and expertise pool in Scotland and of Scots.

Finally, the design of a new tax system, or any form of tax devolution, is so large a responsibility it cannot and should not be rushed. It will be far from easy to design and to implement. The inevitable efforts and pain need to be because the case is made based on research and evidence, that something better can and will be delivered. Will it be worth it, and why? Political leaders and others may be interested in the observation in the Mirrlees report “Tax by Design”¹²:

¹² Available from The Institute of Fiscal Studies website at <http://www.ifs.org.uk/mirrleesReview/design>, page (iv).

“In addition to administrative practicality and the difficulty of turning economic intentions into robust legislative language, proposals for tax reform are, of course, constrained by politics – not least the unfortunate observation that those who lose from tax reforms tend to be vengeful while those who gain from them tend to be ungrateful.”

If early tax devolution is decided upon, it will only be practical to adopt the current UK tax system with as little change as possible, but with the administrative system costs to be borne. A fresh approach will probably take at least a decade of effort and disruption to achieve. But not to take those steps could be to compromise on principles and opportunities, for the reasons set out in this paper. That could lead voters to the stark question: is there then a real point to tax devolution?

The key questions

It is proposed that six key questions need to be answered to move the debate forward, and determine what should be on the tax agenda for Scotland. Each of these is addressed in overview below. One caveat however: this is not intended as a complete thesis but rather an overview, based on existing research and publications, and ICAS experience, from which insights and ideas might be drawn. Other questions and approaches will no doubt emerge, and the issues of practicalities can be addressed as a next step, but an agenda for a debate is always useful.

The starting point for a new tax system is a blank sheet of paper. There is only one assumption; that raising taxes is essential to fund public services. It may be helpful to apply the debate to known or given factors, such as the population profile of Scots and business base as at the start of 2012, but only insofar as it may prove the revenue-raising adequacies of the tax system once designed, not to affect the design.

Question 1 - What principles should determine the ideal tax system for Scotland?

Developed economies' tax systems are a relatively modern phenomenon, most having seen exponential growth in the last 50 years. Tax systems are also man-made, by politicians with a generally limited understanding of the detail of what they do and limited control over the tax administrations they appoint as operators.

It follows then that the people should shape the decisions on the governing principles to be applied, and the establishment of tax policy, by engagement in the debate with elected leaders and policy makers. High-level engagement is perhaps more practical than universal involvement in the detailed drafting of the legislation and the design of the administrative steps that put those principles into practice and make the tax system a reality. But an understanding of the consequences is relevant to the decisions on principles; these consequences need to be considered without allowing them to impede progress on design.

Thinking about tax from the basis of principles, through policy, to practice, is neither new nor particularly controversial for Scots. Adam Smith started this in 1776 in his “Inquiry into the nature and causes of the Wealth of Nations”, with four maxims with regard to taxes; the burden proportionate to the ability to pay (sometimes called a progressive tax approach), certainty, convenience and efficiency of collection. Many of these principles were reflected in an exercise undertaken by The Institute of Chartered Accountants in England and Wales in 1999, when it identified “Ten Tenets for a better tax system”.¹³ These comprised principles behind a better tax system; that a tax system should be: statutory (enacted and scrutinised by Parliament), certain, simple, easy to collect and to calculate, properly targeted, constant, subject to proper consultation, regularly reviewed, fair and reasonable, and competitive.

Similar themes were echoed when the current UK Government defined its view of the principles for the UK tax system in 2011 as:

- *“Taxes should be efficient and support growth;*
- *Taxes should be certain and predictable;*
- *Taxes should be simple to understand and easy to comply with; and*
- *The tax system should be fair, reward work, support aspiration and ask the most from those who can most afford it.”*¹⁴

These short and simple principles are rather neat. Scotland can come up with its own, or have a different emphasis. It is when these principles are translated into policies and legislation that it becomes more interesting, as trade-offs, contradictions and piecemeal developments start to add weaves of interaction and complexity. To understand more about these issues, and prepare for the next questions on the list, time would be well spent with a read of the 2011 Institute for Fiscal Studies Mirrlees Review, “*Tax by Design*”¹⁵ (or even just its introduction¹⁶). That paper’s detailed examination of the topic raised further concepts and 21st-century factors influencing policy designs, such as:

- the changing importance of particular business sectors in the economy
- the changing demographics in the working population and households
- the interaction with benefits systems (negative taxes) in addressing inequality in incomes
- globalisation, particularly the role of technology in international business transactions
- the influence of the European Union, with its control over VAT and dislike of tax havens.

The debate in recent months has focussed on the competitiveness of a tax system, particularly focussing on the headline corporate tax rate. For the purposes of this exercise,

¹³ Available from the ICAEW website at <http://www.icaew.com/~media/Files/technical/Tax/Tax%20policy/Ten%20Tenets%20for%20a%20better%20tax%20system>

¹⁴ HM Treasury website at http://www.hm-treasury.gov.uk/tax_index.htm.

¹⁵ Available from The Institute of Fiscal Studies website at <http://www.ifs.org.uk/mirrleesReview/design>

¹⁶ Available from The Institute of Fiscal Studies website at <http://www.ifs.org.uk/mirrleesreview/design/ch1.pdf>.

this particular question would ask where competitiveness as a principle would sit in the relative priorities of the tax system design, rather than fix an answer or target rate.

One caveat however, the European Union's rules on tax systems, and State aid in particular, cannot be ignored – unless of course Scotland is not part of the EU. The European Parliament is also considering enthusiastic proposals by a number of European countries, towards a Common Consolidated Corporate Tax Base¹⁷; effectively an EU set of tax rules for companies based in the EU, overriding domestic provisions, except for decisions on tax rates. Disputes over EU tax issues take a long time to resolve.

The answer to Question 1 sets the aspirations and principles to underlie the rest of the tax system design.

Question 2 - Should tax play a wider role than raising revenue?

Wider policy issues can sometimes enhance, and sometimes confuse, tax principles. What other role, if any, should tax play in a future Scotland?

The tobacco industry tax has for a long time now been associated with the costs of treating the health consequences of smoking, regardless of whether that was its original purpose. The recent debate on the costs to health and health systems of alcohol abuse, even with significant alcohol duties already applying has raised this as an issue again, albeit in Scotland as a minimum pricing issue given the lack of tax powers.

A choice may be made to address the obesity issue with a tax on selected foods; that debate has been taken forward recently by Denmark in its introduction of a tax on foodstuffs with a higher fat content, and Hungary with a similar response but a broader categorisation including sugar¹⁸. Sugar taxes in fizzy drinks are under serious consideration in parts of the USA. In all of these, tax is seen as a route to influence behaviour against consumption, based on what a government considers unhealthy.

Moving beyond health, Bill Gates' report to the G20 leaders Cannes Summit in November 2011¹⁹ also supported carbon tax measures, to address climate impacts and address issues of social responsibility and redistribution of wealth on a global scale. These principles can also be localised; the UK already has a landfill tax aimed at encouraging recycling but is redistribution of wealth a design feature to build in, and how?

This might also be a time to consider whether national insurance contributions should be recognised as a tax, in that they generate revenue for current public spending outflows, rather than as a set aside to fund future retirement provision on a compulsory contributory principle, or both.

After addressing Question 2, the system design principles at least start to take shape.

¹⁷ European Parliament Committee on Economic and Monetary Affairs Draft Report 2011/0058 November 2011.

¹⁸ See observations on the new Institute for Fiscal Studies project to investigate the impact of these types of policies, available at <http://www.ifs.org.uk/publications/5712>.

¹⁹ "Innovation with Impact: Financing 21st Century Development"

Question 3 - Who should pay tax in Scotland?

The Mirrlees report mentioned above included recent tax yield and demographic statistics for the UK, which can be taken, at best, as a proxy for the shape of those statistics for Scotland for the purposes of starting this debate. (Let no-one be misled, there are no official statistics for tax paid by those in Scotland, simply because there has never before been a need to measure them and the mechanism has never been set up. This is discussed further under question 6 below).

The first need is to define who would, and would not, be a Scottish taxpayer? Start with individuals, where we can look to recent work in connection with the proposed Scotland Bill provisions to allow limited income tax varying power to the Scottish Government. (Companies currently have a separate tax regime.) Both the UK and Scottish Governments took a straightforward approach to taxation of individuals, fitting those limitations, of regarding “Scottish taxpayers” as a subset of “UK taxpayers”, broadly on the basis of where their main home was. A number of anomalies were found as to the treatment of mobile workers; naturally any existing anomalies in the determination of a “UK taxpayer” would carry through. That taxpayer base has the advantage of relying on known rules (albeit the UK rules are likely to change in 2013) and having an automatic default for an individual Scottish taxpayer to being a UK taxpayer, so setting out the tax boundary with the rest of the UK.

However, if starting with a blank sheet of paper, would the Scotland Bill’s approach to income tax be the optimal one? An example of one disadvantage of the approach is given by the current definition of a “Scottish taxpayer” being based on the definition of a UK taxpayer, according to rules of UK tax residence. That Scottish taxpayer “subset” could then be altered by UK decisions, taken at Westminster, on the definitions of UK tax residence, decisions not taken in Scotland and subject to potential ongoing change, albeit that the changes may only affect a relatively small number of taxpayers.

Perhaps those rules aren’t ideal, given that the latest UK consultation process is being extended due to issues with the complexity of the proposals and their impact²⁰. Do other international regimes provide the answer?

For companies, is it just Scottish incorporated companies, or any companies with places of business in Scotland, or selling to or from Scotland which should pay tax in Scotland?

Whether a company is incorporated in Scotland or England and Wales has had so little impact in recent years it has been a decision of administrative convenience at the time of

²⁰ See Written Ministerial Statement “Non-domicile taxation and statutory residence test” from HM Treasury 6 December 2011, available at <http://www.hmrc.gov.uk/budget-updates/06dec11/wms-non-dom.pdf>

set-up rather than of import or consequence for the vast majority. The place of business rules might be expected to dominate.

For international businesses - which would then, by definition, also include those who do business inside and outside Scotland but within the UK - this area is fraught with complexities in compliance. Tax jurisdictions across the globe try to make sure they have their fair share of taxing rights; through defining who pays tax, and also what will be taxed in each tax regime – known as the transfer pricing issue. Each tax jurisdiction demands proof that transfer prices have allocated fair profits and tax to the appropriate exchequer, so the administrative consequences of these rules for businesses operating across the UK could be significant and result in an increased compliance burden. ICAS expressed its concerns on this matter in representations submitted in 2011²¹; subsequent comments have been in relation to the balance between any advantage of a lower tax rate against the disadvantage of a greater administrative burden for all.

Beyond that, a number of key exemptions are granted in different tax systems, commonly for organisations such as charities (including schools and universities). Focused exemptions are also given to particular types of income; these vary from miners' free coal, to employees' Christmas parties (within limits) and asbestos compensation, from electricity micro generation to players in the UEFA Champions League Final 2011. The list of reliefs examined by the Office of Tax Simplification in its March 2011 report²² identified 1,042 in the UK tax system although a small number (less than 50) mainly of limited use or expired, have now been removed. In comparison to the existing system, there is no doubt that simplification could be achieved. The Office of Tax Simplification reports about reducing the complexity of tax reliefs and interactions within the system could also be read as a list of "things to avoid putting on the blank sheet of paper", but also demonstrate the consequences in a tax system of trying to do too much for too many different interests. Which leads to question 4.

Question 4 - What should be taxed?

Probably the most fascinating of all questions relating to this matter, as it really includes separate issues of the tax source (the activity, such as earnings or profits, ownership of capital or wealth, consumption), the taxable amount (the calculation of the earnings or profits, less reliefs or exemptions) and the tax rate(s). All of these separately and together are what makes a tax system, not just the tax rate.

This is also where the interaction of the principles becomes evident. For example, if one chosen principle for the tax system is simplicity, then the system design would have simple rules for taxable activity – such as all earnings, profits, gains, pensions – then apply one of the

²¹ ICAS response to "Rebalancing the Northern Ireland economy" 1 July 2011, available at <http://icas.org.uk/home/technical-and-research/technical-information-and-guidance/tax/tax-submissions/>.

²² Office of Tax Simplification "Review of tax reliefs Final report" March 2011.

simplest taxable amount calculations – the cash receipt – and tax rates would be a simple fixed and flat percentage.

But if another chosen principle is that a fair tax system should be based on ability to pay, then a simple flat tax rate does not deliver that; progressivity of higher tax rates for higher incomes and greater affordability would be demanded.

Why is the existing UK tax regime so much more difficult? A simplistic answer is because of legislative baggage, because cash receipts can be manipulated - if your employer pays your rent directly to the landlord, whose taxable receipt is it? - and are not currently regarded as giving the recognised measure of the net economic or business performance or health. However, the possible use of cash receipts and other simpler approaches for smaller businesses are now the subject of an HMRC consultation²³, following a review by the Office of Tax Simplification²⁴ and the Department of Business, Innovation and Skills²⁵; their research and observations will be informative in this debate.

Radical outcomes might be possible and practical. The UK system currently has separate systems for taxing investment income and capital gains, once realised. The rules are lengthy and complex. Other countries have tax systems based not on realised income and capital gains, but a deemed return on invested capital; the Netherlands for example taxes an annual 4% deemed return on relevant wealth; ability to pay is simply assumed and the compliance burden much less. Some of the alternatives to consider based on other jurisdictions' practices were set out in the Office of Tax Simplification report referred to above.²⁶ Would, or should, inheritances be taxed? Many estates now involve trust arrangements (a trust being a legacy of protection of land and wealth in past generations, perhaps as far back as the Crusades) and a large proportion of the tax code deals specifically with this area. Is it worth looking again at this for the Scottish taxpayer base? Much value is still held in the form of land, on which a transfer tax (stamp duty land tax) is currently payable. What about a simpler, combined approach to taxing these?

This also leads to the question of what activities or groups should be favoured, or otherwise, in the ideal tax system. Do we continue the UK system of favouring entrepreneurs on capital gains and inheritances on the basis that they are employment creators and should be incentivised? Certain types of growth-related activity, such as research and development, often gain support, but again we get back to principles. If economic competitiveness is a key principle, does that mean favouring particular sectors or activities, and which ones, and how? Usually this means adjusting the tax base (the taxed profits) rather than the tax rate, but international tax competitiveness is an ever changing field. Any government needs to make

²³ HMRC "Simpler income tax for the simplest small businesses" March 2012

²⁴ The Office of Tax Simplification "A simpler income tax for the smallest businesses; a discussion paper" July 2011

²⁵ Department for Business Innovation and Skills and the Financial Reporting Council's "Simpler Reporting for the Smallest Businesses" Discussion Paper, August 2011 .

²⁶ The Office of Tax Simplification "A simpler income tax for the smallest businesses; a discussion paper" July 2011

sure that the form of any tax rate or tax base reductions do result in economic growth and so tax yield replacement, rather than a permanent loss of tax revenue without any benefit.

With an ageing population, could Scotland afford to continue the more generous personal allowances for the over 65s, particularly if there is tax relief given on pension contributions – even taking account of the recent Budget announcements? With the challenge of getting school-leavers into work is it worthwhile improving their chances of being employed by giving them and their employers’ tax breaks, or more relief for training costs? Is it time to integrate income tax and national insurance contributions, which might highlight that earned income is more highly taxed than unearned income, and taxed according to different rules? This is not to discuss mainstream party politics but to suggest how wider consideration in our blank-sheet-of-paper world may highlight some different approaches needed for the 21st century.

William Pitt in 1796 presided over taxes on dogs, windows and male servants. Recent calls have been made for taxes on carrier bags, cyclists and tourists. ‘Who pays?’ is always difficult to answer and exercises many minds; popular consensus on this may take time.

It is also necessary to consider taxpayer behaviour, and the behavioural response to tax legislation and changes. Most people don’t like paying tax. Most people will try to avoid paying tax, mostly within the law (tax planning or avoidance) but sometimes outside it, through tax evasion. So whilst you can design any tax system you want, it needs to be workable and collect what you want it to.

This means mechanisms to pursue tax evasion and address tax avoidance; a strong compliance and enforcement regime penalising evasion may be needed. For tax avoidance, the decision is about what behaviours to tackle; where is the line between acceptable and unacceptable tax planning? Another principled debate is needed here for the tax system to be designed, with contributions no doubt from informed sources such as Graham Aaronson QC’s Study Group report on anti-avoidance legislation²⁷.

Finally, there is the geographic question, particularly for businesses operating overseas as well as in the UK. Does the system aim to tax profits generated in Scotland, or owned by Scottish companies, or use another approach? The UK is at present party to a number of international tax agreements, which, according to the Organisation for Economic and Social Development’s principles, determine the jurisdiction with taxing rights over property or income, and of relevance to companies and individuals. Territoriality has become the emerging theme for the taxation of international business groups globally. Whether some protest groups like it or not, the UK and many other jurisdictions permit, indeed have rules designed to facilitate, an acceptable level of tax planning internationally. Should Scotland sign up to the same principles of territoriality and network of double tax treaties independently? Would this be an absolute necessity in order to gain the tax efficiencies they deliver for businesses located here, such as not having a cash-flow disadvantage from suffering

²⁷Available from http://www.hm-treasury.gov.uk/d/gaar_final_report_111111.PDF

withholding taxes, which is key to competitiveness, and being an acceptable, never mind attractive, business location. Is there a credible argument for taking sectoral favours further and adopting tax haven status for money box companies based here, as is the case for other small jurisdictions such as the Channel Islands? How would the EU view that?

The shape of tax systems changes whichever jurisdiction is reviewed, but each needs to be seen in its entirety, rather than piecemeal. This is probably a matter where learning from overseas systems could be most informative.

Question 5 - Who should run any new tax system in Scotland?

Once the tax system is designed, the administrative resource can be aligned accordingly. Even more decisions are then needed; what accountability should there be of that resource to the Scottish Government? Recent examination of HMRC by the House of Commons Public Accounts Committee has revealed gaps in expectations of governance, never mind scrutiny, of the HMRC Board; the outcome of the current Cabinet Office review might be informative. But with Scottish Parliamentary procedures and principles already in place, how would these be built on to achieve the types of performance management and accountability that a tax authority might be expected to deliver?

The UK tax system is run by HMRC, based on massive IT systems developed over many years. Would a devolved tax system require a new Scottish tax administration to be established or would it be outsourced to HMRC? What would it cost and how long would it take to establish? With a largely England-based technical division, and following recent reorganisations, HMRC has arguably neither the expertise nor capability to staff a Scottish Tax Administration without major re-engineering.

HM Treasury and London based HMRC staff currently drive the majority of policy decisions; the current HMRC staff in Scotland do not have the range of policy and management experience, nor operating structure, to operate a separate tax system at this time.

This question was identified in the Scottish Government paper last year²⁸ but perhaps the question would need to be addressed with a specific design in mind. If an outsourcing approach is considered, why limit consideration to HMRC; why not consider, say, the Australian administration, which on some National Audit Office analysis seems to operate with greater efficiencies²⁹? Bear in mind also the potential lack of economy of scale in a tax system run for Scotland, at less than 10% of the size of the UK; a different cost-effectiveness and efficiency model from that for the UK may be desirable to achieve value for money.

Question 6 - What would be needed to implement any tax devolution in Scotland?

²⁸ Corporation Tax: Discussion Paper Options for Reform, August 2011.

²⁹ Report "HM Revenue & Customs Engaging with tax agents" 13 October 2010.

This is a bit of a chicken and egg dilemma; until the process of designing a tax system is complete, including who should pay tax and on what, it is impossible to know what it will yield and therefore whether it will achieve its economic tax raising purposes. The data that might be needed to prove economic effectiveness, such as statistics for the Scottish taxpayer base of individuals and businesses, is not held by anyone at present; for the simple reason it has never been, nor had to be, collected. A significant data-gathering exercise seems on the horizon if there is to be any tax devolution, as well as extensive economic and behavioural modelling exercises. The Barnett formula impact debate may use or provide some of this data as well.

Then there remains the need to identify the Scottish taxpayer base. How? There are no complete, tax-system-ready records of who is in Scotland at the moment (if that's the tax base you decide). HMRC can select details according to postcode but only for those "live" on the system, and there are serious concerns over data accuracy. Reporting of address changes, immigration and emigration render this an ever moving target. The issue for companies was set out above – there is a less immediate linkage of taxable profits to postcodes, given businesses may have many offices or depots – so that exercise too is needed to decide which companies and what proportion of business profits would fall within a Scottish tax net. The compliance burdens and competitiveness impact were outlined in ICAS representations in summer 2011³⁰ and addressed at page 6 above.

Any departure of all the Scottish taxpayers (once defined) from the UK tax regime would introduce the scope for potentially interesting negotiations with HMRC on handover matters, such as tax deferrals or exit charges from the UK tax system, as arise for those leaving UK tax residence. This may result in a requirement for the establishment of a separate tax administration for any devolved tax powers or jurisdiction, or some other mechanism to avoid "HMRC Scotland" arguing with "HMRC UK"; a situation commonly agreed to present quite a conflict of interest and accountability.

The tax provisions would then have to be passed into legislation, possibly a lengthy process of drafting and review. There are around 80 Acts of Parliament at present relating to UK tax and national insurance contributions with provisions in effect, not to mention a huge quantity of secondary legislation and guidance.

The massive volume of existing legislation is directly related to the number of things the tax system is trying to do; the number of taxes, types of taxpayers, rates, reliefs etc – complexity – plus the drafting style of the legislation. That people just don't like paying tax mean that a plethora of anti-avoidance provisions abound, not always very efficiently or effectively. Whilst in theory a different approach to legislative drafting might be taken with the blank sheet of paper system, it would be a drafting approach not yet developed.

³⁰ICAS response to "Rebalancing the Northern Ireland economy" 1 July 2011, available at <http://icas.org.uk/home/technical-and-research/technical-information-and-guidance/tax/tax-submissions/>.

At present it takes a UK Government at least a year, probably nearer two, to shape, draft and enact one Finance Act, so getting to grips with a realistic timescale for any tax devolution is essential, even once the Scottish Parliamentary processes and procedures have been decided. To design and implement an independent tax system in Scotland from scratch may realistically take at least a decade if not two, shorter if a more limited devolution of powers is involved. Transitional provisions for taxpayers to move from the UK to any new system would also need to be considered, with decisions on changeover dates and records, and no doubt lots of forms to be filled in unless smart thinking is applied. Adopting the conclusions of the Mirrlees³¹ report might shorten this process, but only perhaps if it received wide support. It may be that as a matter of practical reality the decision is made to adopt the existing UK tax system with the potential for devolved changes over time, but that will defer, rather than avoid, this debate.

Good and clearly established relationships with overseas tax jurisdictions are key to business and economic competitiveness, through the operation of the Double Tax Treaty network as well as cooperation agreements. It is likely these would need to be established and maintained for a devolved tax system as well. Changes to tax systems do not necessarily cause the principles in Double Tax Treaties to fail, but what is the position of any change in the tax authority at the same time? Would any devolved or independent negotiating position be seen as weaker, being from a smaller and newer tax authority? A clear position on how any tax system changes would impact on business competitiveness in this area is an early requirement.

This final question is the one where practicalities and processes loom largest. Given the competitiveness agenda of most countries in economically challenging times, and the need for many for certainty in a world where uncertainty may be seen as risk, is it important that a process and timetable for this debate, or the destinations, are set out sooner rather than later? Or is time better spent in design and on principles? ICAS members welcomed the sentiments behind the UK Coalition Government's Corporate Tax Roadmap in 2010, and would welcome continuation of those principles of a clear direction of travel. As stated above, this paper is about starting the debate on tax system design options in the light of the devolution debate. Much more will no doubt be written in due course on the practicalities.

But whichever tax future is chosen, there is likely to be agreement that it would be helpful to optimise the benefits of a chosen system and minimise the costs and adverse consequences of change - we come back again to an area where ICAS members contributions to the debate may be hugely valuable.

11 June 2012

³¹ Available from the Institute of Fiscal Studies website at <http://www.ifs.org.uk/mirrleesreview/design/ch20.pdf>.

The ICAS debate

A basic tenet for this paper is that ICAS members have a contribution to make to the debate on Scotland's future, its meaning and implications for those in Scotland, the rest of the UK and beyond. ICAS has a duty to act in the public interest, which means that we should contribute information and insights to the debate, based on the considerable interest and experience of our members in technical areas such as taxation, but including also pensions, governance and regulatory matters.

This paper is the first in a series that aims to do this; we are seeking to ask the questions in key areas that those on all sides of the debate should address over the coming months.

Members are invited to contribute their views on this taxation paper, the questions it identifies or those that should be added, deleted or altered. Written responses can be emailed to tax@icas.org.uk, preferably by the end of May 2012. After the initial round of member consultation and debate, it is envisaged that wider events and discussions will take place later in 2012.

For the avoidance of doubt, ICAS will not be taking any political perspective or taking a stand for or against any referendum proposal.

Dr Iain McLean FBA FRSE—Written evidence

Introduction

1. I am a professor of politics at Oxford University and a fellow of Nuffield College. I have been working for many years in the field of your inquiry. I am a Fellow of the British Academy and of the Royal Society of Edinburgh, and helped to organise the two academics' double conference on these matters (in London in February 2012, and in Edinburgh in April 2012).
2. At those conferences, there were expert presentations on some of the subjects of your inquiry, especially about the economic fate of Ireland after 1921 and of the components of Czechoslovakia after 1992. I have asked for the transcripts to be sent to you separately. I could attempt a précis in oral evidence.
3. With that possible exception, my evidence concerns only QQ1-3 in your Call for Evidence. I am not qualified to comment on Q4.
4. I have written, and given evidence, elsewhere on the economic implications for Scotland of Scottish independence (see in particular my evidence to the 2007-11 Scottish Parliament Committee on the Scotland Bill), which I do not repeat here but can supply on demand. Therefore this evidence focuses on implications for the rest of the UK minus Scotland (RUK).
5. A general point to begin with: the economic implications per head for RUK of Scottish independence, whatever the detailed arrangements, will be much less than its economic implications per head for Scotland. This is for reasons of simple arithmetic. As the population of Scotland is less than 10 per cent of that of the UK, any changes in transfer payments between Scotland and RUK will have a trivial impact on taxing and spending in RUK. A perception that RUK is 'subsidising' Scotland may be politically relevant, but is not very relevant to your inquiry.
6. I broadly agree with the memorandum you have had from Prof. Robert Rowthorn. Where I have nothing to add to his analysis, I do not comment further.

Division of the UK's public assets, liabilities and expenditure

7. The following supposes that the Scottish people have voted for independence, and analyses your questions in the context of the post-referendum discussions between representatives of Scotland and RUK. It also considers the contingency that a majority of voters in Orkney and Shetland have voted against independence. While this would have no legal or constitutional impact on the scenario, it would undoubtedly have an impact on post-referendum bargaining.
8. The division of non-defence-related public assets would be uncontroversial. They would be divided according to their physical location.
9. The division of defence-related assets would be controversial only if or insofar as the Government of RUK wished to retain a lease on assets in Scotland. The cases which have already been discussed are RAF Leuchars and Kinloss; and, most crucially HMNB

Clyde, essentially comprising the submarine base at Faslane and the armaments store at Coulport. As is well known, HMNB Clyde is the home of the United Kingdom's strategic nuclear deterrent, in the form of nuclear submarines armed with Trident missiles. It is also one of the largest employment sites in Scotland.

10. Informal discussions suggest that both the current Scottish Government and the UK MoD regard HMNB Clyde as their trump card: i.e., in the event being discussed, each thinks that its card will force the other to make major concessions. They cannot both be right.
11. Traditionally, the policy of the Scottish National Party has opposed the siting of nuclear weapons in Scotland, and has stipulated that an independent Scotland would not be a member of NATO. The party's leaders wish to change this last commitment, and are in the process of taking their proposal to their members. The results are unknown. Should party members reject their leaders, it would paradoxically strengthen the leaders' hand in the event of independence negotiations, because the representatives of Scotland would be in a position to insist that the submarines and missiles must be removed from HMNB Clyde within an agreed timescale.
12. In that event, the commonly-known difficulty of finding a site in RUK which satisfies the operational requirements of the MoD and which avoids any highly controversial local opposition to new sites for the storage of nuclear warheads, in a timely manner, might force RUK to make concessions to Scotland on other matters.
13. However, it may be more enlightening to look at an aspect of the British-Irish agreement of 1921 that Prof. Rowthorn does not discuss. This is the creation of the "Treaty ports" of Berehaven, Queenstown (Cobh) and Lough Swilly. Article 7 of the Treaty states: *The Government of the Irish Free State shall afford to His Majesty's Imperial Forces (a) In the time of peace such harbour and other facilities as are indicated in the Annex hereto, or such other facilities as may from time to time be agreed between the British Government and the Government of the Irish Free State; and (b) In time of war or of strained relations with a Foreign Power such harbour and other facilities as the British Government may require for the purposes of such defence as aforesaid.*
14. A similar arrangement was made between Russia and Ukraine after the break-up of the Soviet Union, to allow the Russian Black Sea Fleet to continue operating out of a base in Ukraine.
15. In 1921 the UK and Ireland had just fought a guerrilla war. The stakes were vastly higher than in the scenario being discussed in this memorandum. Nevertheless, the lead British and Irish negotiators on Article 7 (Winston Churchill and Lord Birkenhead for the UK; Michael Collins and Arthur Griffith for Ireland) were able to reach an agreement in which the smaller country accepted terms demanded by the larger for its military protection. Collins, the military leader of the Irish guerrilla forces, probably saw that the bases would allow the Irish Free State to take a "free ride" on defence provided by the UK against hostile third parties.
16. However, no government can bind its successor. Article 7 was renegotiated in 1938, and the UK Government relinquished control over the treaty ports. With hindsight, that was singularly badly timed. Likewise, the government of Ukraine, when controlled by anti-Russian parties, has given Russia notice to quit the base at Sevastopol.

17. It is also relevant that a non-nuclear weapon power may nevertheless be prepared to host nuclear weapons within a military alliance, as is the case with Turkey, Italy, the Netherlands and Belgium, and even in Germany where there is a comparably strong anti-nuclear popular feeling to Scotland.
18. On the liabilities side, the issue is whether Scotland should take a share of UK debt proportionate to population, or more, or less.
19. Prof. Rowthorn's memorandum suggests that the starting position of Scotland might be to decline to take any on. However, it is equally plausible that the starting position of RUK would be that Scotland must take on more than its population share, on the grounds that the two biggest banks to have collapsed in 2008-9 were both Scottish. A letter from the First Minister to the then Sir Fred Goodwin has recently surfaced, in which the First Minister encourages the Royal Bank of Scotland's then chief executive "for Scotland" to complete the merger with ABN-AMRO which led to the collapse of the bank. It is certain that this letter would form part of RUK's bargaining position.
20. Both of these bargaining positions are probably unrealistic. It is likely, therefore, that the bargaining would converge on the position arrived at between the British and Irish in 1921 – again, in that case between countries that had recently been at war, one of which was considerably poorer than the other.
21. As noted by Prof. Rowthorn, Article 5 of the 1921 Treaty states: *The Irish Free State shall assume liability for the service of the Public Debt of the United Kingdom as existing as the date hereof and towards the payment of War Pensions as existing at that date in such proportion as may be fair and equitable, having regard to any just claim on the part of Ireland by way of set-off or counter claim, the amount of such sums being determined in default of agreement by the arbitration of one or more independent persons being citizens of the British Empire.*
22. The contingency of Orkney and/or Shetland having voted against independence would have no constitutional effect, but would strengthen the relative bargaining position of the RUK.

Currency, monetary policy and central banking

23. Scotland would have three options: to adopt the £ sterling, the euro, or create a new currency with a central bank (and, presumably, monetary policy committee) to support it.
24. The policy of the SNP was formerly to adopt the euro as soon as possible. Formally, the EU requires this, as well as acceptance of the Maastricht conditions on deficit and debt, as part of the *acquis communautaire* for a new member state. Scotland would probably be treated as a new member state for this purpose.
25. However, the SNP now states that it will retain the £ for the time being. The EU would be in no position to insist otherwise, even if the euro still exists at the time of Scottish accession.
26. If sterling continues to be used in Scotland, the Bank of England could only be required to take into account Scotland's economic conditions in setting monetary policy if this were made a condition of the independence treaty in the post-referendum bargaining. I

cannot see that Scotland would have any lever over the RUK to force it to make this a condition, therefore I assume that it will not be.

27. If this assumption is correct, then the RUK would retain an intense interest in financial regulation in Scotland. To avoid a “mini-Greece” scenario, the RUK might insist in the independence negotiations that the regime of financial regulation in Scotland must be cleared in advance by the Bank of England.
28. The only counter-threat available to Scotland in that case, that I can envisage, would be that Scotland would unilaterally adopt the £ sterling without specifically asking permission, as Ecuador and Argentina have done with the US dollar at times.
29. However, this counter-threat might alarm Standard Life, the Scottish Widows’ Fund, and Aberdeen Asset Management sufficiently that Scotland would be unlikely to use it.
30. For the same reason, I think that the pound Scots is not a realistic option. It would be more likely to depreciate than to appreciate against sterling in the first days and weeks. The history of the Czech and Slovak crowns immediately after the “velvet divorce” could be relevant here.

Fiscal policy and taxation

31. As stated in paragraph 5 above, the implications (in comparative statics terms) of the fiscal implications for RUK of Scottish independence are rather small. Two flows of roughly equal and opposite magnitude would cease. Tax income from the Scottish sector of the North Sea would cease to flow to RUK. Social protection transfers and Barnett consequentials from the UK Treasury would cease to flow to Scotland. The per capita implications are relatively serious for the average Scot, but relatively trivial for the average citizen of RUK.
32. A vote against independence from Orkney and Shetland does not change this much. In this I somewhat disagree with Prof. Rowthorn. I cannot envisage that the independence negotiations would result in an RUK including the Northern Isles: i.e., a country of two detached portions surrounding Scotland. The analogy of East and West Pakistan is not exact but sufficiently close to be worrying.
33. Rather, I expect that, as above, it would enable RUK to drive a harder bargain with Scotland on the price to be charged for the common services which the Scottish Government has signalled that it wishes to share: viz., head of state; overseas representation; perhaps military services; perhaps macroeconomic management and financial regulation.
34. In bygone days, such a payment was called an “imperial contribution”. It featured heavily in discussions and proposals for Irish Home Rule between 1886 and 1972 (for it nominally continued under that name in Northern Ireland until the abolition of Stormont in 1972). In the negotiations now envisaged, it would have a different name but the same function.
35. The effects of tax competition between Scotland and RUK would be relatively minor. Here, the biggest foreseeable risk surrounds Corporation Tax. Scottish politicians are

very tempted by the example of the Republic of Ireland, which for decades has attracted mobile industry with low corporation tax rates.

36. Should Scotland lower its corporation tax rate, there would be a deadweight loss as firms with operations both in Scotland and in RUK would immediately package their activities so as to maximise their taxable receipts in Scotland and minimise those in RUK. This would be pure deadweight loss from the perspective of the current UK.
37. Conversely, should Scotland raise its corporation tax rate, firms would do the opposite. Here there is an asymmetry, because any loss would mostly be borne by the Scottish taxpayer.
38. However, the fiscal prospect for an independent Scotland is poor, as Prof. Rowthorn's work shows. It is important to note that his numbers mainly come from the official Scottish Government (and National Statistics) publication GERS (Government Expenditure and Revenue in Scotland). In the first years after independence, it would be difficult for the Scottish government to cut corporation tax rates.
39. Variation in VAT would lead to huge retail sheds going up in either Gretna Green or Carlisle. More importantly, it would lead online traders to "locate" in whichever part of the present UK offered them the most favourable tax regime. As with corporation tax, variation would lead to a deadweight loss. Amazon's recent establishment of a base in Jersey for its online sales offers a case in point.
40. Variation in income tax, and its proxy, National Insurance, would have relatively little effect in the short term. Labour is less mobile than capital, and people choose where to live for many reasons among which relative tax burden is unlikely to be dominant.
41. The taxes where an independent Scotland would be least constrained would be those on the most immobile factor of production, viz., land. As an independent Scotland would inherit a truly dreadful basket of land taxes (Council Tax, Business Rates, and Stamp Duty Land Tax), it would have an excellent opportunity to pluck more feathers with less hissing than at present. But such moves towards tax efficiency would have few knock-on effects, because land is where it is.
42. The extreme volatility of North Sea Oil revenue poses a serious problem for Scotland but none for the RUK unless Scotland approaches fiscal collapse a la Greece. By assumption, the regulation of Scottish debt and deficit will have been discussed in the independence negotiations with RUK and with the EU. As negotiators will all be aware of the fiscal risk arising from a collapse in North Sea Oil revenue, they will have an incentive to design robust institutions.

This version 22 June 2012

Newcastle International Airport Ltd—Written evidence

Please accept the following short representation, on behalf of Newcastle International Airport Ltd, to the Call for Evidence on The Economic Implications for the United Kingdom of Scottish Independence.

- 1 The possible devolution of APD to Scotland raises huge issues for other regional airports, particularly those closer to the Scottish border. Devolving APD to the Scottish administration, given their keenness to reduce the rate of APD in order to give Scotland a competitive advantage, would have a devastating impact upon Newcastle Airport.
- 2 We have set out an alternative proposal to address the impact APD is having upon regional airports and the economies they serve. This proposal would involve the varying of APD rates according to the level of congestion at an airport, rather than where that airport is located. This approach would in our opinion be legal under EU State Aid rules, and would be fair. A devolved approach, whereby passengers – who are essentially mobile between airports – could pay significantly less north of the border than they would pay south of the border, would in our view be certainly very unfair. It would lead to the loss of a significant number of direct and indirect jobs in the North East of England and make this region even more of an economic backwater than it is or deserves to be.
- 3 In the event of devolved APD, and should the Scottish Government elect to reduce the rate or cancel the Duty altogether, we anticipate that both passengers and airlines would move from Newcastle to airports north of the border, particularly Edinburgh. For example, Emirates, an airline we have worked hard to acquire and retain, would be able to offer its customers far cheaper flights from Edinburgh and would therefore be likely to consider relocating its service. We are certain there would be numerous other examples, and we are genuinely concerned that the future viability of Newcastle Airport could be threatened.
- 4 The consequences for the economy of the North East of England of such a move would be equally devastating. The Eddington Report concluded that the region is already relatively poorly connected when compared to other UK and European city regions. The economy of the region also has a range of other disadvantages. The loss of a number of critical air services would be hammer blow, setting the region back both in terms of private sector activity and the outlook and aspirations of its population. Large and international employers could have to review their presence in the region, and the tentative growth seen in inbound tourism would be reversed.

11 June 2012