

# THE SCOTTISH GOVERNMENT'S PLANS FOR INDEPENDENCE

AN ANALYSIS  
FROM BUSINESS

## The economy is at the heart of the debate about independence

### **The decision on Scotland's future is rightly one for the Scottish people**

There are a wide range of factors on which people in Scotland will make their choice. But as many polls suggest, the effects on Scotland's economy and business environment are vital in many Scots' minds. The importance of this cannot be overstated: it concerns their jobs and their prospects for a better life, inside or outside the United Kingdom (UK).

The role of businesses is to highlight what the economic effects of a 'yes' vote or a 'no' vote on 18 September 2014 might be, how their plans could change – or not – and the risks and opportunities that separation holds.

In this brief, the CBI contributes to this debate through an assessment of the Scottish government's white paper on independence, *Scotland's future: your guide to an independent Scotland* ('the white paper'), published on 26 November 2013. The white paper positions the economy as one of the principal reasons why Scotland would be better off as an independent country. Here we assess that argument, and the arguments for remaining part of the UK.

*Our conclusion is that the white paper does not offer a coherent vision for how or why an independent Scotland would be better off from erecting barriers between itself and its biggest export market.*

*Devolution provides the benefits of local leadership, and while an independent Scotland could remain economically competitive, the loss of many of the strengths of the Union would open the nation to a higher risk from economic shocks. Independence would be a major economic upheaval with uncertain consequences.*

*For this reason, we believe that the best way to deliver jobs and prosperity for the people of Scotland is for Scotland to remain a part of the UK. In short, Scotland and the UK are stronger together.*

## Independence matters for businesses across all nations of the UK

The CBI is the UK's leading business organisation, speaking for some 240,000 businesses operating across the UK. With offices across the country as well as representation in Brussels, Washington, Beijing and Delhi, the CBI communicates the British business voice around the world.

CBI members directly employ at least 500,000 people in Scotland, which represents a quarter of the private sector workforce. This includes companies headquartered in Scotland as well as those based in other parts of the UK that have operations and employ people in Scotland.

The issue of independence is also of huge importance to businesses all over the UK, not just companies headquartered in Scotland. Businesses all around the UK have operations and employ people in Scotland, reflecting the highly interconnected nature of the economies of the nations that make up the UK. On this basis, our response has been developed on the basis of wide consultation with our members in Scotland and throughout the UK.

And it's important to remember that independence will affect businesses operating in Scotland in different ways depending on what kind of business they are. Multinationals serving world markets from a Scottish base or Scottish-based businesses with large customer bases in other parts of the UK might face more costs from independence than businesses whose customers are primarily in Scotland, for example.

## Business wanted answers to major economic questions

After the 2011 elections to Holyrood, CBI members started from the position of wanting to understand the case for independence and the Scottish National Party (SNP) government's plans and vision for the business landscape in the event of it happening.<sup>1</sup> The white paper was positioned as the answer to this challenge from a wide range of Scottish bodies, in business and elsewhere. The CBI in particular wanted to understand the case through a thorough and detailed explanation and vision of what independence would look like, how it will be achieved, what it would mean for our economy and the management of economic policy, and what the business environment would look like and how it would work.

We recognise that in a few instances complete clarity would have to await the outcome of any negotiations between the Scottish and UK administrations following any referendum vote in favour of independence, or between the Scottish administration and relevant international institutions such as the EU.

However, for many other aspects the Scottish government could and should have provided clarity over what it would like to achieve and how it would go about it well in advance of the referendum. This would inform a productive public debate and also provide certainty, allowing businesses and others to assess the merits of what is being proposed and plan ahead accordingly.

To support the Scottish government in preparing the white paper, in 2013 the CBI set out the key questions about independence that businesses felt needed to be fully addressed to provide voters with the information that they need to make an informed choice. The questions focused on important areas for the future of Scotland's economy including its public finances, monetary policy, trade and position in the world, as well as the future of some of Scotland's key industries such as financial services, defence, energy, higher education and food & drink.

Since the white paper was published, the CBI has undertaken an analysis in order to determine the extent to which these major issues have been addressed. This paper presents the outcome of this analysis.

### Key findings:

- Scotland's success is underpinned by being a vital part of a dynamic and outward-looking UK economy
- The white paper's vision for an independent Scotland lacks clarity and coherence on issues that are vital for future economic success
- Independence opens key sectors of the Scottish economy to increased risk.

<sup>i</sup> The CBI has a rich history of engagement on constitutional public policy matters that affect business. In 2006 we published a detailed position paper on the 'Powers of the Parliament'. Since then we have contributed to the Scottish government's National Conversation, the Commission on Scottish Devolution (Calman), the Scottish government's discussion paper on devolving corporation tax, the UK and Scottish administrations' consultations on the referendum process, HM Treasury's consultation on devolved government bond issuance, as well as the current Commons' Scottish Affairs Committee and Lords' Economic Affairs Committee inquiries into independence. We recently published a 'referendum toolkit' for our members to assist their practical consideration and assessment of what Scottish independence might mean for their organisation, their staff, their customers, supply chain and business operating environment.

## 1 Scotland's economic success is underpinned by being a vital part of a dynamic and outward-looking UK economy

In this section we look at some of Scotland's major economic strengths and argue that:

- Scotland in the Union is an economic success story...
- ...and success is achieved and driven by being part of a dynamic and outward-looking UK economy
- Devolution means Scotland enjoys flexibility combined with the security and opportunity that comes from being a vital part of the UK.

### Scotland in the Union is an economic success story...

The Scottish economy is emerging strongly from the shadow of the global economic crisis. Its growth rate has been almost exactly the same as the equivalent figure for the UK over the past 40 years.<sup>1</sup> Moreover, upon independence Scotland would be one of the wealthiest nations within the OECD, coming eighth out of all OECD nations in 2011.<sup>2</sup> The white paper is clear on the many advantages which Scotland boasts – educational institutions among the world's best, natural resources which have historically accounted for a strong offshore economy, and a range of strengths in key sectors. These have been built up over decades through an evolving partnership with the other nations of the UK. The highly respected economist Professor Gavin McCrone has been clear that the issue is not Scotland's sustainability as an independent nation, but whether independence is the best choice in 2014, when compared with the value of staying in the union. He has been clear that the union is the better choice economically under current conditions.

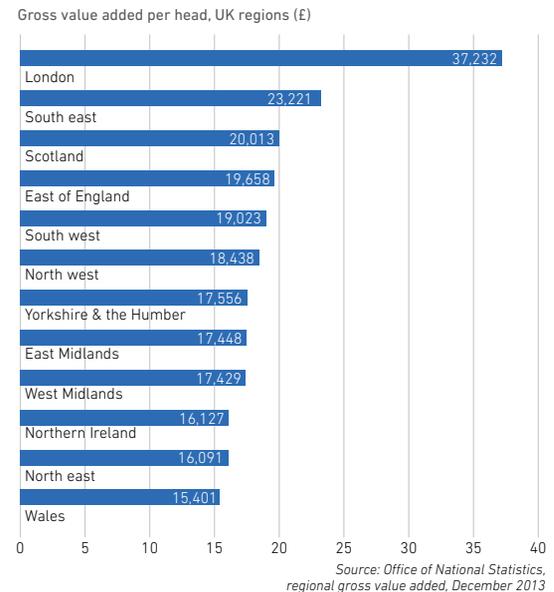
### The Scottish economy performs well compared to countries of a similar size...

Accounting for a full geographical share of North Sea oil & gas, Scotland has higher output when compared to economies of a similar size such as Denmark and Finland.<sup>3</sup> Scotland has also fared well in relation to these comparator nations in recovering from the financial crisis. Losses in output from a pre-crisis peak were larger in Denmark, Finland, Ireland, Luxembourg and Portugal than they were in Scotland.<sup>4</sup>

### ...and it boasts a strong position relative to other parts of the UK

Scotland's economy compares favourably with the rest of the UK. Scotland's gross value added (GVA) per head was behind only London and the south east of England in 2012 at 94% of the UK average (**Exhibit 1**). Focusing in on the north east of Scotland, the home of the UK's offshore oil & gas industry, GVA per head is second in the UK only to central London, at 144% of the national average in 2011.<sup>5</sup>

**Exhibit 1** Scotland's GVA is third-highest in the UK



Scotland's current employment rate (72.8%) is higher than the UK's overall (72.1%) and London's (71.3%), although it trails the rates for the south east of England (76.6%), south west of England (74.6%), and the east of England (75.7%).<sup>6</sup> On labour productivity too, Scotland has a strong performance. It ranks third in the UK behind only London and the south east of England for output per hour worked, and fourth for output per job only slightly behind the East of England.<sup>7</sup>

### Scotland has world-beating sectors of the economy

Scotland is home to a range of world-beating industries, including in defence, financial services, energy, higher education and food & drink. In the creative industries, it was a game developed by the Edinburgh based firm Rockstar North – Grand Theft Auto V – which achieved worldwide retail sales of over \$1bn in less than three days, and which recently won Best Game Design at the BAFTA video games awards.<sup>8</sup> In other areas, Scotch whisky accounts for about one quarter of all UK food & drink exports.<sup>9</sup> On the global stage, Scotland's strengths represent UK strengths.

### ...and success is achieved and driven by being part of a dynamic and outward-looking UK economy

There is no doubt that Scotland has many major strengths which contribute to its economic success. And today's success is achieved as a highly-integrated part of a dynamic and outward-looking UK economy.

With common institutional structures and market ties that date back over at least three centuries to the 1707 Act of Union, if not earlier, the economies of Scotland and the rest of the UK are necessarily highly complementary.<sup>10</sup> They share many of the same challenges today. Emerging from the financial crisis – the effects of which were greatly exacerbated by an over-reliance on debt-fuelled consumption – the imperative for both Scotland and the rest of the UK (rUK) is to further rebalance growth towards business investment and trade.

### Being in the UK helps businesses in Scotland sell to the world

The UK approaches the rebalancing challenge with some key strengths: Scotland is part of a United Kingdom which possesses a prominent global trading role with over 65% of the UK's GDP linked to trade – a higher ratio than the equivalent for France (57%), Italy (59%) and Japan (31%).<sup>11</sup>

Scottish Development International (SDI) provides Scotland with a world-class service to bring inward investment into Scotland and offers support for exporters and businesses looking to set up operations overseas. In addition, through UK Trade & Investment (UKTI) and the commercial diplomacy practised by the UK Foreign Office, businesses operating in Scotland have access to vital further supporting infrastructure that helps them export their products and services. The UK supports 169 trade and investment offices in over 100 countries, as part of over 220 global diplomatic missions, selling Scotland and Scottish goods to the world. This global trade promotion network extends substantially further than would be available to an independent Scotland.

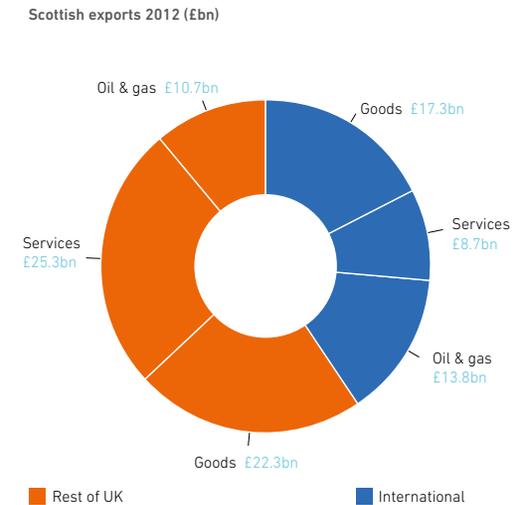
By being in the UK, Scotland also benefits from a scale which amplifies its global influence through multinational bodies such as the European Union (EU). Through the UK's membership of the EU, businesses in Scotland have access to the world's largest single market worth £15trn: 45.1% of UK exports and 46% of Scottish exports go to EU consumers.<sup>12</sup> And the scale of the UK gives Scottish voices clout in Brussels.

Scotland and rUK both face the same challenge of needing to boost their trading ties with emerging markets. Both export substantially more to low-growth developed economies like the Netherlands and Ireland than to high-growth emerging markets like Mexico and Indonesia.<sup>13</sup>

### ...and the profound integration of Scotland and rUK's economies yields massive benefits for businesses on both sides of the border

Being part of the UK provides businesses in Scotland with a firm platform from which to access global markets, but Scotland's main export destination remains closer to home. The seamless access

### Exhibit 2 Scottish exports to rUK outstrip exports to other destinations



Source: Global connections survey 2012 – 'oil & gas' counts the exporting of unrefined petroleum products not classified under 'goods' (CBI analysis)

provided through a borderless internal market makes rUK by far and away Scotland's biggest trading partner. While Scottish exports were worth £98.1bn in 2012, Scottish exports to rUK outstripped Scottish international exports by some £18.5bn (**Exhibit 2**). And the UK's status in the EU is also vital, with 46% of non-oil and gas exports going to other EU member states.

In addition to the benefits yielded by internal trade, a fully integrated labour market allows relative ease of movement, with 33,000 working age people moving from rUK to Scotland in 2011 and another 35,000 moving in the opposite direction.<sup>14</sup> It is this critical combination which provides multinational firms based in Scotland, Scottish firms, and firms with operations on both sides of the border with the certainty they need to invest and, in turn, generate value for the Scottish and broader UK economy. In goods and services, on regulation and currency, and through individual workers, the UK brings significant agglomeration benefits to Scotland. These benefits would inevitably ebb away after independence as two sets of policies are pursued by two governments which cause the two economies to diverge, especially without single regulators and a currency union.

*'In goods and services, on regulation and currency, and through individual workers, the UK brings significant agglomeration benefits to Scotland'*

### Devolution means Scotland enjoys flexibility combined with the security and opportunity that come from being a vital part of the UK

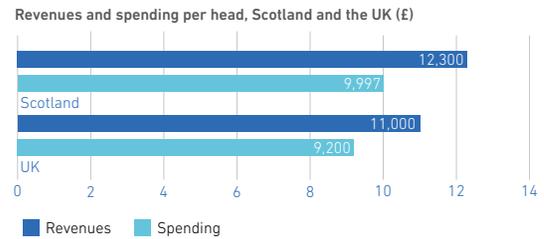
In 1997, the Scottish people voted in favour of a devolutionary settlement for Scotland by a clear majority. The Scotland Act 1998 confirmed powers on a new Scottish parliament with its members elected by the Scottish people. Currently, 60% of the total spending allocation for Scotland is devolved from the UK government to the Scottish government. This covers areas such as justice and policing, local government, health and education while reserved powers (the responsibility of the UK government) cover areas such as defence and foreign policy.

#### Through devolution, Scotland can steer an independent course from the rest of the UK on major issues affecting the future of its economy...

Under the devolution settlement, Scotland has taken a decision to depart from rUK in its spending profile in a number of key areas. For example, Scotland spends more than three times the UK average per person on economic development, over 50% more per person on transport, and over 97.3% more on housing.<sup>15</sup> Furthermore, Scotland also funds commitments such as free higher education and free personal care. Overall, this comparatively higher per capita spending on publicly owned assets and other priorities means that spending per head is higher in Scotland than for the UK as a whole.

The question is whether Scotland can afford this higher per capita spending. **Exhibit 3** plots revenues and spending per head for Scotland and the UK for 2012-13, assuming a geographic share for North Sea revenues. On the basis of these figures, Scotland's overall outlook is worse than the UK's – both spending and revenue is higher in Scotland, but Scotland has a larger gap between revenues and spending per head than the comparable figure for the UK. The exact level of this gap in a given year will depend on the revenues accrued from one sector of the Scottish economy in particular – North Sea oil & gas. In some years the gap has been reversed, with Scotland having a smaller deficit. Currently, the rest of the UK can act as a buffer if these oil revenues disappoint, mitigating the impact on Scottish finances through fiscal transfers within the internal market. However, should revenues in an independent Scotland come in lower than expected, an independent Scotland would be forced to re-evaluate its spending choices in order to arrest the development of a significant fiscal gap. We evaluate these possibilities in more detail in the next section. In effect, the scale of the UK shields public services designed, funded and implemented in Scotland by Holyrood, from a highly variable revenue stream.

### Exhibit 3 The gap between what Scotland spends per head and recoups through tax was greater than for the UK as a whole last year



Aside from spending, much of the debate over recent years has focused on taxation: specifically, the scope of the Scottish parliament's tax setting and collecting powers, and the potential for these powers to be extended. At present, 7% of the tax receipts collected by the Scottish government are raised in Scotland, in the main through receipts from council tax and business rates.<sup>16</sup>

In 2009, the Commission on Scottish devolution (Calman Commission) recommended that further possible tax powers be extended to the Scottish parliament and, as a result, the Scotland Act 2012 included provisions for several more powers to be devolved.<sup>17</sup> For example, from April 2016, the main UK rates of income tax in Scotland will be lowered by ten pence and the Scottish parliament will be given the power to set its own rate of income tax. Moreover, the Scottish parliament will also assume full responsibility for taxing disposals of waste to landfill and stamp duty taxation on property and land from April 2015.<sup>18</sup> The business community in Scotland does not regard a 'no' vote in September as closing off opportunities for further debate around the right balance of powers between London and Edinburgh within the Union.

#### ...and the real benefits for Scotland come from combining the positives of devolution with the stability and opportunity afforded by being in the UK

Being part of the UK offers Scotland a range of advantages that overarch the devolution framework. A stable, respected reserve currency, low barriers to trade and a greater capacity to withstand economic shocks are all key positive ways that Scotland benefits from being part of the UK.

As we point out in the next section, the extent of Scotland's fiscal position's dependence on a few sectors, including energy and financial services, means that the fiscal resilience of Scotland under independence would be significantly lower than it is today. Revenues from oil & gas have varied between £6bn and £12bn just in the past couple of years, for instance, while the 2008 UK bank rescue package for banks based in Scotland cost more than the entirety of Scottish GDP. It is the Union that provides the scale and resilience to deal with these economic headwinds.

## 2 The white paper's vision for an independent Scotland lacks clarity and coherence on issues that are vital for future economic success

Having established that Scotland performs well as part of the UK, the key question for businesses must then be around the extent to which becoming fully independent would be better or worse for the economies of Scotland and rUK.

In this section, we analyse the white paper's proposals in four key areas which the CBI regard as the critical macroeconomic factors for business in Scotland:

- Scotland's fiscal outlook
- The viability of a sterling currency union, and what any Plan B would be
- The fragmentation of the UK's single market
- An independent Scotland's transition to full membership of the EU.

**We conclude that on all of these issues, the white paper's vision lacks clarity and coherence, opening up risks which could undermine an independent Scotland's future economic success.**

Specifically, we argue that:

- The significant challenges that independence would create for Scotland's public finances are underplayed in the white paper
- A sterling currency union is not viable – yet we have not seen a Plan B
- Breaking up the internal market would increase costs for businesses and consumers on both sides of the border
- Securing EU membership is unlikely to be a smooth process, and Scotland's terms of membership could leave it worse off

**The significant challenges independence would create for Scotland's public finances are underplayed in the white paper**

**In the short term, an independent Scotland would need to prioritise deficit reduction**

Scotland faces the same fundamental economic challenge as the rest of the UK: the need for fiscal consolidation in order to restore the economy to a sustainable position after the financial crisis.

**Exhibit 4** takes a historical look at Scotland's net fiscal balance to show that Scotland's path of deficit reduction has been close to the equivalent path for the UK, although the exact GDP share of Scotland's deficit has fluctuated markedly from year to year.

The latest account figures produced by the Scottish government highlight that even with a full geographical share of North Sea oil & gas receipts,

### The white paper on Scotland's public finances

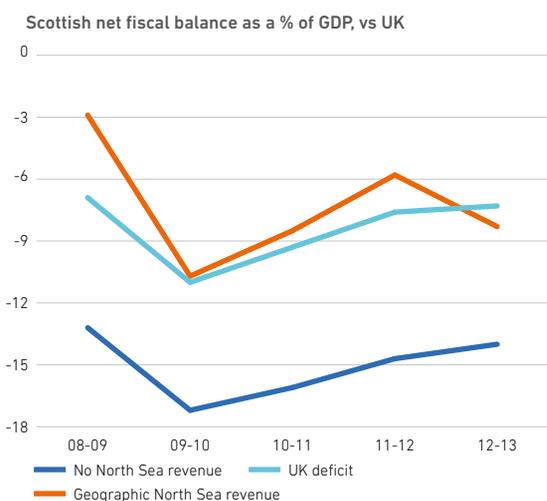
The white paper argues that public finances in Scotland have been 'consistently healthier' than those in the UK. It asserts that over the last five years, Scotland's public finances have been stronger and its ratio of public spending to GDP has been lower than for the UK as a whole. Furthermore, it notes that total Scottish tax receipts in 2011/12 were equivalent to £10,700 per head as opposed to total receipts worth £9,000 per head in the UK as a whole.<sup>19</sup> Looking ahead, the Scottish government forecasts that an independent Scotland would start with a deficit of between 1.6% and 2.4% of GDP in 2016/17 based on Scotland taking on a historic share of UK debt.<sup>20</sup> Alternatively, they forecast that Scotland's deficit will be between 2.5% and 3.2% of GDP with a population share of UK public sector debt.<sup>21</sup>

These figures are contingent on Scotland being awarded its geographic share of oil & gas assets from the North Sea which, in practice would mean that Scotland would receive an estimated 94% of North Sea revenues.<sup>22</sup>

Scotland's deficit was still a sizeable 8.3% of GDP in 2012-13 – more than for the UK as a whole.<sup>23</sup>

Moreover, these same figures show that excepting North Sea oil receipts, Scotland's onshore economy had a substantial budget deficit of 14.7% of GDP in 2011-12 and 14.0% of GDP in 2012-13<sup>24</sup> – demonstrating how dependent an independent Scotland's economy would be on unpredictable offshore revenue (see below).

**Exhibit 4** The size of Scotland's deficit compared to the UK's overall has varied in recent years



In addition, the likely higher level of rates on Scottish government bonds by comparison to those of the UK government will place a further weight on Scottish finances, as Scotland begins to issue its own debt, rather than making payments against its share of UK debt.

Ongoing fiscal consolidation is therefore of the utmost importance, not just for the UK, but for an independent Scotland's economic outlook. Credibility with the markets in the event of independence will depend on tax and spending plans which acknowledge and action this need for short-term fiscal restraint.

**Over the long-term, Scotland's public finances would be dependent on revenues from its vital oil & gas sector, which are volatile in nature**

The offshore oil & gas industry is one of the UK's major economic strengths. Its products power industry, heat homes, and provide fuel to transport goods and people. Its economic footprint is amplified through an extensive supply chain, and it makes a major contribution to the UK economy in terms of tax revenues, technologies and exports. Clearly, on independence, the sector would form an even more crucial part of Scotland's economy. The tax revenues accrued from the sector would also impact on an independent Scotland's net fiscal balance (**Exhibit 4, page 6**).

The revenues from these critical commodities are by their nature volatile, meaning that the total amount raised fluctuates year-by-year. In the last four years, Scottish Government figures show that revenues from the North Sea have amounted to £6.5bn in 2009-10, before rising to £8.8bn in 2010-11 and again to £11.3bn in 2011-12, with a fall to £6.5bn in 2012-13.<sup>25</sup> These changes are due to a range of factors including fluctuations in the global oil price, maintenance costs for supporting infrastructure and alterations to the tax regime.

There is also a downward trend in terms of the actual crude oil and natural gas produced that will inevitably lead to a decline in revenues over the long-term. Indeed, official figures show that production has fallen to just under a third of the UK's peak production recorded in 1999.<sup>26</sup> It is clear – as the recent Wood review pointed out – that Scotland will benefit from the North Sea for many years into the future given the right package of investment, but the importance of this overall trend is illustrated by the fact that since the 1999 peak, Scotland has had one of the lowest GDP growth rates in the OECD, reflecting the fact that falling oil revenue has acted as a drag on the wider economy.<sup>27</sup>

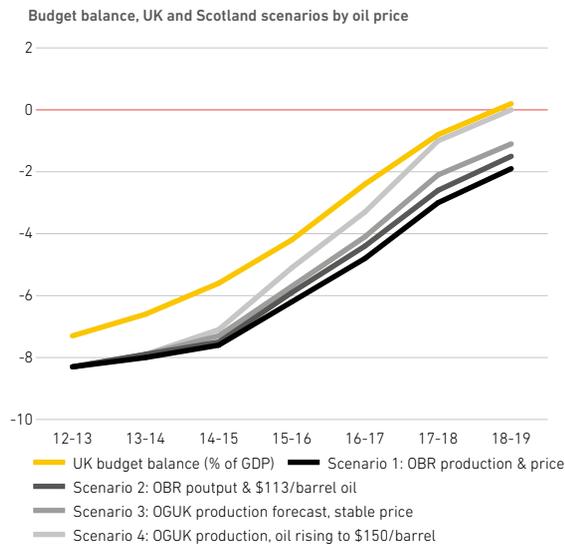
The Scottish government plans to mitigate against the volatility of oil & gas revenues by establishing a Scottish Energy Fund to invest proceeds from the North Sea into both a short-term stabilisation fund and then a long-term savings fund. This would be a positive move and welcomed by business. Building on international precedents like Norway, once operational such a fund would help Scotland to cope with year-on-year fluctuations in oil & gas revenues and mitigate against declining production over time. However, as addressed in detail below, there are significant issues inherent in getting the fund up and running, given the significant short-term challenge of deficit reduction.

*'Since the 1999 peak in oil & gas production, Scotland has had one of the lowest GDP growth rates in the OECD'<sup>28</sup>*

Crucially, the fluctuations in North Sea revenues mean that Scotland's public finances are subject to greater volatility when compared with the public finances for the UK as a whole. In 2012-13, North Sea revenues only accounted for 0.5% of UK GDP, while in an independent Scotland North Sea revenues would have accounted for 4.8% of GDP. This volatility is a concern in its own right, but also because it makes fiscal planning difficult. For example, since the 2013 autumn statement, the Office of Budget Responsibility has revised down its forecast for oil and gas revenues by £3bn. Constructing a market-credible fiscal plan on the basis of such an unpredictable revenue stream would be a challenge for an independent Scotland.

Therefore, any future projections for Scotland's deficit in the medium to longer term (such as those included in the white paper) and their comparison with the UK's deficit will depend on particular forecasts for North Sea revenues in the future. CBI analysis in **Exhibit 5** models the likely path of Scotland's deficit over the next five years according to differing forecasts for North Sea revenues (and assuming the best case scenario of Scotland securing a full geographic share of North Sea output). This analysis sets out the baseline case for Scotland's overall fiscal framework – it provides the background context within which the Scottish government will have to fund spending commitments set out in the white paper. We assess the affordability of these commitments further below.

### Exhibit 5 Scotland's long-term budget balance depends on the scenario for oil & gas production



From this analysis, we can see that, depending on which forecast is used for North Sea revenues, there are differing paths for Scotland's future deficit reduction needs:

#### Under forecasts from the independent Office for Budget Responsibility (OBR), an independent Scotland would have a larger fiscal deficit than the UK

In 2012-13, Scotland ran an underlying fiscal deficit of 8.3% compared with 7.3% for the UK.<sup>29</sup> The OBR forecasts that North Sea production will remain at its current low levels and that the price of oil will fall in line with current forward prices towards \$99 per barrel by 2018-19. Under the OBR's forecast, Scotland's fiscal performance will deteriorate relative to the rest of the UK. Scotland's fiscal deficit will widen from being 1% higher than the UK's deficit in 2012-13 to 2.4% higher than the UK's deficit in 2016-17, the proposed year of independence. If Scotland were to become independent in 2016, its fiscal deficit would be 4.8% of Scottish GDP, (which would be in excess of the 3% maximum deficit required by the EU's Growth and Stability Pact). CBI analysis suggests that if the OBR's oil and gas production forecast is correct, then the oil price would need to increase to \$186 per barrel for Scotland to match the UK's fiscal performance over the period.

#### Under industry forecasts, an independent Scotland is still likely to have a larger fiscal deficit than the rest of the UK

The Scottish government has cited production figures from Oil & Gas UK's (OGUK) Activity Survey 2013 to suggest that an independent Scotland's fiscal performance will match the rest of the UK. OGUK's 2013 survey forecast a recovery in North Sea

production from 1.45 million barrels of oil equivalent per day (BOEPD) to over two million BOEPD by 2017. However, this forecast growth has now been revised down in the 2014 survey. Although still more optimistic than the OBR, the latest OGUK forecast expect production to grow to 1.7 million BOEPD in 2017. In 2016/17, using the Scottish government's preferred assumptions, a \$113 oil price and the latest OGUK production forecast, this would result in Scotland having a deficit of 4.1% of GDP, which would still be 1.7% of GDP higher than the UK's forecast budget deficit of 2.4% of GDP. Scenario 4 shows that even with a \$150 oil price combined with OGUK's production forecast, an independent Scotland would struggle to match the UK's fiscal performance. Adopting OGUK's production forecast, an independent Scotland would require an oil price of \$155 a barrel to match the UK's fiscal performance.

#### These fiscal challenges have clear policy implications which the white paper does not reflect...

CBI analysis shows that an independent Scotland would at a minimum need to follow the UK government's pace of deficit reduction, even accounting for the most optimistic (\$150 per barrel) North Sea production forecasts and current oil prices (**Exhibit 5**). If we assume the Scottish government's preferred assumptions of \$113 per barrel oil and the recovery in production forecast by OGUK 2014 Activity Survey an independent Scotland would need to make £2.1bn in addition to the UK's fiscal consolidation to match the UK's fiscal performance.

Furthermore, an independent Scotland would both have no fiscal history and be dependent on volatile North Sea oil & gas production for over 10% of its tax revenues. As the ratings agency Standard & Poor's noted in February 2014, diminishing North Sea oil reserves would be "...proportionally a larger drag on Scotland's future GDP performance unless the decline in volume energy output could be reversed".<sup>30</sup> Therefore, it is likely Scotland may even have to consolidate its fiscal policy on an accelerated timetable relative to the rest of the UK to establish its credibility with the markets.

#### ...and the spending commitments made are not affordable

This challenging fiscal context calls into question the tax and spending plans set out in the white paper. The Scottish government's stated immediate policy plans are fiscally neutral, with, broadly speaking, increases in welfare spending being paid for by a sharp reduction in the defence budget. But their longer-term plans appear less fiscally prudent, with apparently unfunded commitments to the tune of £670m, which would represent a 0.4% deterioration in an independent Scotland's budget (**Exhibit 6**).

In total, £920m of long-term spending commitments have been made, with £250m stated to be clawed back over the course of an independent Scottish government's first term in office. But the white paper does not detail the anti-tax avoidance measures that would be put in place, nor does it take into account the fact that the UK government already plans substantial UK-wide anti-avoidance measures, which were expanded once more in the most recent budget. It is not clear what extra could be achieved in Scotland, especially given the fact that this would need to be delivered in the throes of establishing the Scottish revenue and customs organisation. Given this, the actual size of unfunded long-term commitments could be closer to the £920m figure, which would amount to a 0.6% deterioration of the budget.

Many of the Scottish government's spending aims are laudable, but as the previous analysis has made clear, the fiscal backdrop will make them difficult to afford and it is debatable whether the policy aims would be easier to deliver under independence than in a devolved Scotland as part of the UK.

As highlighted above, the white paper's commitment to start a Scottish Energy Fund would in principle be a positive move. However, the key test is whether these plans would be affordable given the wider fiscal position, particularly as analysis suggests that the size of contributions to a Scottish fund would amount to less than a tenth of the current size of the Norwegian Fund after 17 years of contribution.<sup>31</sup>

#### Exhibit 6: The Scottish government's long-term tax and spending commitments don't add up

Policy	Cost (£m)
<b>Policies to be implemented immediately: policy tightening</b>	
Reducing defence spending from £3bn to £2.5bn a year	-500
Ending the married couples tax allowance	-60
Cancelling the shares for rights scheme	0
Providing streamlined systems for overseas representation	0
Total policy tightening	-560
<b>Policies to be implemented immediately: policy giveaways</b>	
Maintain a commitment to protecting free personal care/prescription/higher education	0
Abolish penalties for under-occupancy of social housing – 'bedroom tax'	50
Moving Energy Company Obligation into general spending	115
Warm Home Discount Scheme into general spending	90
600 hours of childcare to half of all two year olds	100
Equalise earnings disregard between first and second earners for those already in receipt of universal credit	145
Total policy giveaways	500
<b>Short-term fiscal impact (£m)</b>	<b>-60</b>
<b>Impact on Scotland's fiscal position (% of GDP)</b>	<b>0%</b>
<b>Policies to be implemented in the first term</b>	
£250m in first term from simplifying tax system and reducing avoidance	-250
30 hours per week childcare for 3-4 year-olds for 38 weeks a year	600
Cut air passenger duty by 50%	130
Provide a clear timetable for cutting corporation tax by up to 3%	105
Examine the case for increased National Insurance Employment Allowance for small businesses	0
Increase the personal tax allowance, tax credits and benefits in line with inflation	145
<b>Total fiscal impact (£m)</b>	<b>670</b>
<b>Long-term fiscal impact as % of GDP</b>	<b>0.4%</b>

Sources: Scotland's Future, IFS Green Budget 2014, HMRC analysis of budget 2013, CBI analysis of HMRC dynamic effects of corporation tax reductions.

The Scottish government has previously suggested that an independent Scotland could be able to invest an initial fiscal surplus of £1bn or 0.7% of GDP per annum into the Fund.<sup>32</sup> Yet given that Scotland would have to undertake substantial fiscal consolidation, having such a surplus to commit seems unlikely, unless Scotland were to take no share of the UK's national debt coupled with a best case scenario for future North Sea revenues (a situation which is itself an unlikely scenario).<sup>33</sup> An exact estimate of what the available surplus would amount to does not feature in the white paper.

Finally, it would be reasonable to expect an independent Scotland to take on its fair share of the UK's national debt liabilities, a point which the Scottish government has consistently acknowledged. The exact division would be subject to negotiation and estimates vary. For example, National Institute of Economic and Social Research (NIESR) analysis suggests that should the national debt be divided according to population, Scotland's debt to GDP ratio would be approximately 81% in 2015-16 as opposed to 104% for rUK.<sup>34</sup>

### A sterling currency union is not viable – yet we have not seen a Plan B

**The Scottish economy currently benefits from the use of sterling, which is one of the world's most stable and best-managed currencies...**

The international demand for sterling helps keep interest rates low, both for government and the private sector. Indeed, sterling's role as a 'safe haven' currency was a factor behind the record low interest rates charged on UK gilts in 2012, at the height of the eurozone crisis.

For similar reasons, the use of sterling also reduces the chances of a balance of payments crisis, maintaining access to world markets. And the pound's relative stability reduces the uncertainty faced by Scottish exporters and importers.

Additionally, as part of the UK's monetary, banking, fiscal and political union, Scotland benefits from the UK government's fiscal and monetary backing for the banking sector & deposit protection, and counter-cyclical fiscal transfers (such as government expenditure on unemployment benefits).

### Scotland and rUK fulfil some of the conditions of an optimal currency area...

Sterling underpins the agglomeration benefits that the UK brings to Scotland. Having a common language, extensive cultural ties and a long-established single market, Scotland and rUK fulfil some of the conditions of an optimal currency area (OCA). In particular, there is strong labour and capital mobility, a large amount of trade between the two, and their business cycles are well-synced.

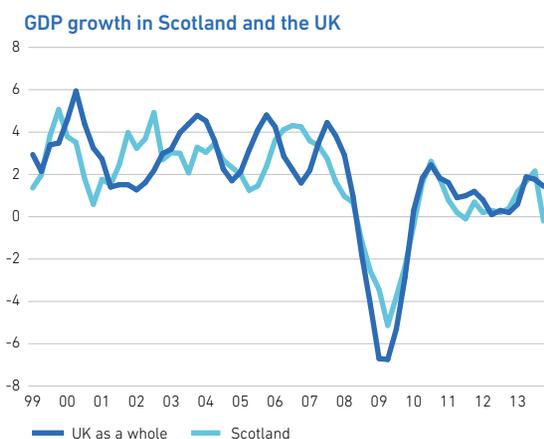
As a result any comparison between a sterling area and the eurozone should acknowledge that Scotland and rUK come a lot closer to fulfilling the criteria of an OCA than the member states of the eurozone, where business cycles varied widely (**Exhibit 7** compares and contrasts Scotland and rUK business cycles with two eurozone economies – Germany and Spain, page 11).

#### The white paper on currency options

Following on from recommendations by the Fiscal Commission, the Scottish government looked at four currency options – the continued use of sterling (both pegged and flexible), the creation of a Scottish currency, and membership of the euro – and has decided that a formal monetary union with the rest of the UK would be preferable. Specifically, the white paper proposes that:

- The Bank of England will be retained as the central bank for both Scotland and rUK, setting monetary policy for the 'sterling area' as a whole. The Bank would be accountable to both Scotland and rUK through a 'shareholder agreement'
- The Bank of England's Financial Policy Committee will continue to set macroprudential policy and regulate systemic risk across the rUK and Scottish financial sectors
- The Bank of England will continue to provide lender of last resort facilities. Both the Scottish and rUK governments will share in any fiscal commitments made to secure the banking sector. However, deposit guarantees for consumers will be managed separately
- Consumer financial regulation to be a competence of the Scottish authorities, but 'closely harmonised' with UK regulators
- There will be a fiscal sustainability agreement between Scotland and rUK.

### Exhibit 7 Scotland and rUK's business cycles are well-aligned



### ...but the eurozone crisis holds some clear lessons about why a sterling area may not be viable...

The experience of the eurozone holds clear lessons about the implications of currency and monetary union without banking, fiscal and political union. Divergent economies sharing a currency will always be put under increasing strain by exposure to monetary policy that does not match economic needs well.

In effect, the Union is a key reason why Scotland and the UK fulfil many of the requirements of an OCA. Although the closely integrated Scottish and UK economies start from a stronger place than the eurozone, Scotland's large banking sector and its likely fiscal challenges (see above) mean that, like the eurozone, a strong banking union, plus fiscal and political coordination would be indispensable components of monetary and currency union.

A critical issue in the discussion of whether a currency union is sustainable is the extent to which the politics and economies of Scotland and rUK might 'grow apart' in the event of separation. Aside from the inherent challenges of a currency union in the financial system, these wider concerns are equally important.

Over time divergences in, for instance, productivity performance would lead to goods from one side of the border or the other becoming more competitive and leaving the other country at a disadvantage. Likewise, a tighter labour market in Scotland, caused by substantial demographic differences with rUK may lead to higher inflation and less competitive production. The inability of Scotland to react to this through its monetary policy would cause profound damage. A similar outcome might ensue from a sudden need for Scotland to increase cyclical welfare spending – for instance at the onset of a recession – where monetary policy could no longer be used as a tool to manage the Scottish economy were the economy of rUK to be in a different position.

Turning to the financial system, the white paper recognises the need for fiscal controls and a banking union backed by public money, and that these would have to be negotiated with the rest of the UK. It does not seem to acknowledge, however, just how deep these would need to be. Yet Scotland's relatively small size and the fact that its trade relies more heavily on other nations than vice versa would make such negotiations extremely challenging. While the Scottish government recognises that monetary union would require a 'sustainable' fiscal framework, it is likely that even if a UK government were minded to support a currency union this would require oversight of and input into budgets as a precondition.

Similarly, the white paper recognises that a viable banking union would require "...shared contributions from the Scottish and Westminster governments", in return for which the UK government would likely require extensive oversight over the regulation of the Scottish financial sector. And if the Scottish financial sector remained substantially regulated by the UK, the case for independence in this area gets progressively weaker.

If a sterling union existed, in order for it to be effective and credible, the decision-making framework over whether and when to intervene in the financial sector and/or resolve failed banks would need to be swift and decisive, with little room for a small minority stakeholder to intervene.

Even if these issues could be overcome, the proposed currency union would be unlikely to provide as much stability as the present arrangement. In particular, there are currently automatic fiscal transfers between Scotland and the other UK regions and nations that help smooth any asymmetric shocks that occur under the UK's single monetary policy (for example, via unemployment benefits). Scottish independence would necessarily entail the loss of important automatic fiscal stabilisers. It would also be more difficult for Scotland to enact counter-cyclical policy under the fiscal rules of a currency union, since the fiscal constraints on an independent Scotland would limit its ability to respond unilaterally to economic shocks that occur in Scotland alone.

One of the key lessons from the eurozone crisis is that a central bank to a single sovereign government implicitly acts as a guarantor for the government's creditworthiness (in a crisis, the government is able to use unconventional monetary policy tools, such as quantitative easing, at the risk of creating inflation). The lack of such a mechanism in the eurozone until the European Central Bank launched Outright Market

Transactions led to runs on the sovereign debt of periphery member states. The white paper says nothing in this area, another where negotiations would likely be extremely difficult, with the rUK government likely to demand extensive powers to intervene in Scottish financial affairs in return for such a facility.

**Exhibit 8** A sterling area would not meet a number of conditions for an optimal currency area

Condition for an OCA	Current UK	rUK and independent Scotland	eurozone
Labour mobility		Historical, language and cultural ties provide strong basis for labour mobility. Some risk of barriers being erected, Scotland's higher need for immigration and EU issues (including whether or not Scotland would be able to adopt the UK's Schengen opt-out – addressed later in this paper).	All Eurozone citizens have the legal right to work in other member states, but there are numerous non-legal limitations like language, culture and differing education standards.
Capital mobility and price and wage flexibility		The fact that Scottish and UK hourly earnings have moved broadly together over time suggests that wage flexibility is strong – but could change if productivity, and tax and regulation regimes diverge.	Price and wage flexibility are limited – witness divergent trends in labour costs prior to 2007 and current divergences in inflation rates.
Automatic fiscal transfers		No proposals for post-independence fiscal transfers have been made or look likely to be politically acceptable.	A fiscal transfer regime for smoothing asymmetric shocks has been proposed by the European Commission but has not been endorsed by Eurozone political leaders.
Similar levels of income		Scottish GDP per capita is 97% of UK GDP per capita.	GDP per capita of poorest member state (Latvia) is 24% of the richest's (Luxembourg) and 52% of Germany's.
Similar business cycles		Business cycles similar to date, but unclear how much of this has been due to political and fiscal integration. Likely divergence over time.	Business cycles have diverged widely, both before and after the financial crisis.
Political union		A viable currency union would probably require Scotland to concede a large amount of sovereignty – more than the white paper anticipates.	No political union – but members have had to concede some sovereignty in order to contain crisis.
Banking union		Banking union proposed in white paper – but details unclear and negotiations likely to be challenging.	Banking union now being implemented in eurozone but only partial – not covering deposit guarantees or a public backstop for the resolution fund.

Source: CBI analysis

## *‘If Scotland walks away from the UK, it walks away from the UK pound’*

George Osborne MP, February 2014

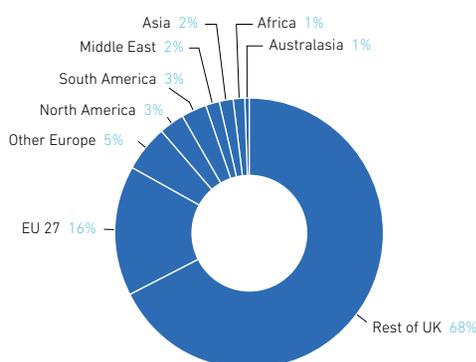
The white paper also stresses that, although the Scottish government would like to achieve a sterling currency union, this would not preclude the Scottish people making a different decision come 2016-17. This presents exactly the currency uncertainty that many businesses want to avoid.

**...and it's far from clear that maintaining a sterling union would be of net benefit to Scotland or the rest of the UK**

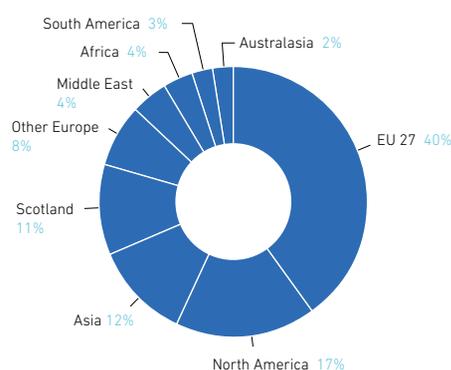
**Exhibit 8** (page 12) provides a CBI analysis of the conditions that would need to exist for the functioning of an OCA and looks at the extent to which they are met by the current UK, the scenario of the white paper's proposed sterling area, and the current eurozone. It finds that many of the key conditions would not be met under a sterling area.

### **Exhibit 9** rUK exports are far more diversified than Scotland's

**Scottish exports by destination, 2012**



**Rest of UK exports by destination, 2012**



Source: Quarterly national accounts Scotland, third quarter 2013 and ONS regional gross value-added (income approach), December 2013

Clearly, a sustainable sterling area could only be achieved with the cooperation of the rUK Government. However, HM Treasury analysis suggests that rUK would not benefit from a sterling area, and it has been ruled out by all three main UK political parties. This is primarily because the Treasury's analysis found that shocks to the Scottish economy had only a limited impact on the UK economy, which limits the benefits of continuing to share a single monetary policy.<sup>35</sup> On the other hand, rUK would have to assume large contingent liabilities for the Scottish banking sector (the Treasury estimates that Scottish bank assets amount to over 12 times its GDP, though the Scottish government has disputed this).<sup>36</sup>

The Treasury's finding that shocks in Scotland have little impact on the rest of the UK appears plausible, since trade with Scotland accounts for a far smaller share of the rUK economy than vice versa. Scottish-rUK trade amounted to £108bn in 2012,<sup>37</sup> which was 101% of the size of Scottish GVA but only 9% of rUK GVA. rUK's exports are far more diversified than Scotland's exports (**Exhibit 8, page 12**).

### **Transaction costs are an issue – but a minor one in comparison to wider risks**

The Scottish government has responded to the recent statement by the main Westminster parties that a currency union was off the table by saying that rUK businesses would be subject to transaction costs due to currency conversion and the associated uncertainty if there was no sterling area in the event of independence.

This is certainly true, especially if a Scottish currency were to float against sterling. However, the Scottish government's estimate that such costs amount to £500m a year is a very rough figure, stemming from a calculation based on a European Commission estimate from 1990 that transaction costs were worth 0.1-0.2% of European GDP (part of the original justification for the formation of European Monetary Union).<sup>38</sup> In practice, transaction costs between the UK and the eurozone have not been as high as many expected in the 1990s.

## *‘A durable currency union requires some ceding of national sovereignty’*

Mark Carney, January 2014

Even accepting the figures used by the Scottish government, such costs look small in the context of a £1.5trn economy and set against the potentially large liabilities of joining a monetary union with Scotland. rUK's trade with the eurozone, and the

associated transaction cost, are much larger than that with Scotland, but the UK opted to enjoy the flexibility and macro-economic stability offered by having its own currency. It is this flexibility which would be denied to an independent Scotland under a sterling area. And for businesses, the risks of an unstable currency union more than outweigh the potential additional currency transaction costs.

#### **A currency union will not be politically acceptable**

The Scottish government appears also to have underestimated the resonance of the eurozone crisis beyond Westminster in the thinking of citizens of the wider UK about a currency union. Bearing in mind the experience of Ireland in particular – and the broad opposition to the UK joining the euro – the stance taken by the Westminster parties is not a political risk: it appears to reflect the wishes of the wider UK electorate. The Scottish government needs to acknowledge that a deal on a currency union requires a willing partner, and the UK is likely to rule it out.

Despite business wishing to retain a single currency across Britain, the economic argument against the UK signing up to a sterling currency union is a powerful one and we do not believe a union will be politically acceptable in rUK. Independence will require a different solution on the issue of currency, which will necessarily be sub-optimal to retaining the pound in Scotland. Businesses need to know what that solution is.

#### **Breaking up the internal market would increase costs for businesses and consumers on both sides of the border**

##### **Businesses and consumers in Scotland and the rest of the UK benefit from deeply integrated internal markets and shared institutions**

The advantages for Scotland of the borderless internal market with the rest of the UK have already been articulated in this paper: Scottish exports to rUK are worth more than Scottish international exports, and capital and labour can move freely in both directions without any transaction costs for British firms.

However, should Scotland become independent, the Scottish and rUK governments, Scottish businesses, and indeed firms with operations on both sides of the border would have to address 'fixed costs' which apply to the common provision of services or functions which would have to be duplicated. For example, running a single diplomatic service for the UK spreads the necessary spending over total UK tax revenue. The requirement to establish a parallel Scottish diplomatic service would mean that the costs of diplomacy would double (unless facilities are shared), but the revenue available overall to each economy from which to meet the costs would fall, as revenues are split. Overall, therefore, there is a net loss of economic utility through greater costs, as well as a greater fiscal burden for each individual economy. Inevitably, this fiscal burden will be transferred to individuals and businesses, either through lower spending elsewhere or through higher taxes.

The same logic for the duplication of government functions applies to costs for businesses. Having Scotland within the UK enables a mutually beneficial trading area to develop with regulatory consistency across all constituent parts of the UK on areas such as:

- Tax, both in terms of reserved rates and administration
- Much of company law and insolvency
- Competition and intellectual property
- Import and export control
- Product standards and consumer protection
- Health and safety, and liability
- Employment and industrial relations issues
- Financial products and services, including insurance and pensions
- Regulation of professions.

##### **The white paper on the UK internal market**

As explored elsewhere in this document, Scotland intends to maintain the pound in a formal monetary union with the rUK with governance and institutional reforms to ensure a Scottish voice in policy setting.

According to the white paper, as part of these plans, financial products and services, including deposits, mortgages and pensions, will remain denominated in the same currency. The white paper imagines that, as part of the same internal EU market, firms will continue to provide products and services to consumers across Scotland the rUK no matter where they are based.

Scotland would ensure continuity of the legal framework for protecting intellectual property rights, developing a cheaper, and simpler model than the UK system, which the white paper calls bureaucratic and expensive.

However, in many areas, including scientific research and healthcare, the Scottish government will work to maintain links and alignment with the rUK, ensuring both countries can benefit from their existing highly developed working arrangements.

### The break-up of the internal market could have a major impact on the motor insurance industry

Independence could have a significant impact on the motor insurance industry, which is the largest class of insurance in the UK.<sup>39</sup> This is an industry with a significant domestic footprint but not much cross-border activity – current figures from the EU single market show that only 1.7% of premiums have been set up through the rules on freedom of establishment and 0.6% of premiums through the rules on free provision of services.<sup>40</sup> Scotland's breakaway from the internal market would require insurers to set up identical infrastructure in a newly separate country which would prove costly in an industry with already tight profit margins.<sup>41</sup>

### Creating a new border between Scotland and the rest of the UK would increase costs for businesses...

Currently businesses comply with a common set of rules without the necessary cost implications of duplication in critical areas, giving firms the certainty they need to plan investment decisions in Scotland and across the UK. The implications for many of these areas have not been mentioned or explored in sufficient detail within the white paper.

For instance, in the event of Scotland becoming a foreign market to the rest of the UK, complex tax rules for cross-border trade would have to be drawn up. Firms would face a significant burden having to comply with different sets of rules, and having to calculate and segregate their taxable profits between an independent Scotland and rUK. The white paper envisages an independent Scotland adopting the UK tax code on day one, however it leaves significant uncertainties about the divergence of tax regimes over time. On corporation tax, for example, the CBI has long believed that the interests of Scotland are best served by a unitary corporation tax system across the UK. This provides the simplest environment for UK and foreign businesses and investors to operate in, and minimises the potential for distortion of economic activity through artificial profit diversion. The costs and considerations of separate tax regimes would be markedly high for businesses which are currently used to the costless ease of cross-border trade throughout the UK.

Another example of the disruption that would be caused is the effect on rules around employment and entry to the labour market. Employment practice in the two states would drift apart over time, for instance requiring different approaches on employee information and consultation or different disciplinary procedures, adding cost to business. More pressingly, demographic factors in Scotland, relative to the rest of the UK, make it likely that demand for Labour from outside Scotland will be higher than the demand for

labour migration in rUK. This raises the likelihood that the right to work in Scotland and the right to work in the UK will not be interchangeable, reducing labour mobility for firms operating across Britain.

### ...and increase costs for individuals too – including on mortgages, credit, clothes and food

The white paper does not make an attempt to acknowledge how a break-up of the UK internal market through independence would result in both a duplication of costs for firms (which are currently under one regime in the UK) and substantial administrative disruption to business operations. Overall, we believe the likely outcome of this is that any increased costs would be passed on to consumers. Some retailers have already made clear that the ending of a single-UK cost base for their operations is likely to mean higher prices in Scotland, where geography makes markets harder to serve.<sup>42</sup> A similar level of dislocation – and higher cost to consumers – might be expected in other big UK-wide markets that would be separately run and regulated... mobile telephony, for instance.

Indeed, Scottish consumers will bear further costs as a result of the uncertainty created both as a result of the break-up of the internal market and the lack of a currency union. The likely impact on the cost of repaying mortgages, for example, has been understated in the white paper as there are good reasons to believe that Scotland's interest rate will be higher than the UK's. Several studies find that the first issuance of sovereign debt by Scotland will be significantly more expensive than the UK's debt.<sup>43</sup> Even in a best case scenario – controlling for Scotland receiving a geographic share of North Sea revenues, a population share of the national debt, and in the event that Scotland forms a sterling area with rUK – it has been estimated that Scotland could face an interest rate premium of between 0.72% and 1.65%. This would be on top of the long run average for the yield on UK ten year gilts at 4.1%, effectively translating into an additional carry-through cost for mortgage payments by Scottish consumers.<sup>44</sup>

And this is not likely to be an issue for homeowners alone – any Scottish person with a loan or credit card would be affected by interest rates which are likely to be higher in the event of independence, something which has not been widely discussed so far in the debate.

Independence would also be likely to lead to an increase in costs for Scottish consumers on children's clothing, new dwellings and food in shops – all areas on which the UK currently enjoys exemptions or lower rates of VAT than usually allowed under EU rules. If an independent Scotland was able to secure EU membership, it would be by no means certain that it could secure the same terms as the UK currently does in this regard.

### Pensions would be significantly affected by the break-up of the internal market

The UK currently has a single national pensions framework which delivers state and private saving to citizens on both sides of the border. In fact, Scottish firms hold vast amounts of pension saving for savers across the UK. Independence means throwing all this up in the air, with an effect on:

- **The state pension:** how will accrued benefit be dealt with, especially for those with a history of working in Scotland and rUK? Will pensions of pensioners from one side of the border who retire to the other be frozen, as they currently are for UK citizens living in other member states? How will the two states go about picking apart accrued rights to the state pension? It is clear that a significant amount of work will be required to manage state pension accrual as the two systems drift apart.
- **Defined contribution (DC) savings:** How will providers in Scotland service savers in rUK, given the differential currency and regulation framework? Without a currency union, it is likely UK savers with Scottish firms will require sterling-denominated funds and the complex interaction of regulatory frameworks may make this increasingly difficult in a cross-border environment.

The Budget announcement on reform to how DC savings are drawn down is an example of how rUK could change its pensions tax rules at a stroke, without substantial effects for providers in Scotland, facing a different regime. This may provide an incentive for firms to relocate some functions.

- **Company pension schemes:** These schemes are currently largely run on a UK-wide basis. While a higher interest rate in Scotland may offer some relief on pensions deficits, for schemes that operate across the UK, EU cross-border rules would apply, which are very onerous for firms. In addition, Scotland would either have to cede power over Pensions Regulation to Westminster or set up its own Pensions Protection Fund (PPF) and Pensions Regulator, which would lead to issues about regulatory competence when the scheme itself is cross-border. In previous examples of legislation on cross-border issues, this has led to the creation of separate schemes as considerable cost to the employer. A Scottish PPF, might also struggle to pay some benefits in the case of a large claim due to the shallowness of the pool of DB sponsors in an independent Scotland.

For example, Scotland's £350m a year publishing industry could be forced to raise VAT from zero to 5% on books and newspapers under EU rules.<sup>45</sup> Other important sectors and daily household expenses, currently VAT exempt in the UK, could face new charges, including goods sold in charity shops, the sale of antiques, equipment for elderly or blind people and children's footwear.<sup>46</sup> Further questions around an independent Scotland's position in Europe are addressed in the next section.

### Securing EU membership is unlikely to be a smooth process, and Scotland's terms of membership could leave it worse off

#### The white paper rightly identifies that full membership of the EU is in Scotland's best interest and would continue to be so on independence

For the past 40 years the UK's relationship with the EU has been the cornerstone of our engagement with an increasingly integrated world. Being in the EU helps the UK connect and work with other states to realise its global ambitions.

#### The white paper on Scotland and the EU

An independent Scotland would seek full membership of the EU. The white paper identifies some of the key benefits of membership as being vital to Scotland's national interest, including access to the single market and the EU's global reach.

It acknowledges that an independent Scotland would be in a unique situation when seeking to secure membership: EU treaties do not currently specify what happens when part of the territory of an existing Member State becomes independent

through a lawful and democratic process. But it argues that Scottish membership would be secured on independence because all EU Treaties currently applying to the UK would apply to an independent Scotland through the principle of continuity of effect.

An independent Scotland would seek to negotiate its membership in the 18-month period between the date of the referendum and independence coming into effect in March 2016.

## 75 % of British businesses say that the EU single market has had a positive impact on their business.

CBI research, 2013

CBI analysis shows that overall membership of the EU is worth 4-5% of the UK's GDP each year, translating into roughly £3,000 per household.<sup>47</sup> British businesses, large and small, want the UK to remain in the EU, at the same time as working to reform it for the better. The Scottish government's white paper rightly recognises these benefits and is clear that Scotland would pursue EU membership on independence.

The EU single market is the biggest in the world, opening up a 500 million-strong consumer market to UK businesses, allowing capital and investment – as well as people and ideas – to flow into the UK and be deployed productively across the continent. This has directly boosted the living standards of UK citizens. As part of the UK, Scotland already enjoys access to this market through the UK's membership of the EU. Scotland exports 46% of its goods and services to the EU, so full access to the single market is a vital national interest.

The EU also anchors trade for Scottish companies around the world. As part of a bloc of 500 million people, the EU gives Scotland major clout when negotiating trade deals. The EU currently anchors

UK trade with nearly 50 partners worth in total over £15trn and this figure could double if the EU completes trade deals currently being negotiated with major players including the United States and Japan. EU membership is therefore essential if Scotland is to maximise trade with existing large markets at the same time as building links to new ones.

### **Independence puts Scotland out in the cold, at least temporarily, with other EU member states in control of its future**

There is no legal precedent or specific provision in EU treaties for an independent Scotland securing membership of the EU. There is conflicting advice from legal experts, with some supporting and the majority disputing the white paper's conclusions that continuity of effect would apply. Significant uncertainty therefore exists around the legal position of Scotland's potential EU membership.

However, the largest impediment to an independent Scotland's bid to become a full EU member is likely to be the political dimension. The EU treaties are clear that Scotland's future EU membership would require approval from all 28 member states. Whether mandating the start of negotiations with

### **The EU supporting Scotch whisky success**

The EU is the industry's single largest export market and is vital to the Scotch whisky industry. Global exports in 2012 were worth £4.3bn, of which sales to the 26 other EU member states accounted for £1.45bn. France is the world's largest Scotch whisky market after the United States, while sales in new EU states like Poland, Romania, Bulgaria and the Baltic nations are growing strongly.

The EU also helps the Scotch whisky industry to sell its products around the world. India, for example, is currently the largest whisky market in the world but Scotch has only 1% of the market. EU pressure led to the Indian government protecting the status of Scotch in 2011 to ensure a level-playing field, and further EU 'wins' on wine and spirits tariffs could bring huge opportunities abroad for one of Scotland's premier industries.

*Source: CBI, Our global future, 2013*

## 78% of all firms favour staying in the EU – with 77% of small and medium-sized businesses saying the same thing.

CBI research, 2013

the newly created state, through signing off the technical details of negotiations in 35 or so areas, right down to ratification of the final accession treaty, an independent Scotland would require unanimous support within the EU before it could become a full member.

However, achieving support from all member states for the admission of a state previously under the EU's umbrella (via UK membership) could be difficult, and political realities may work against Scotland's bid. The existence of secessionist movements in a number of member states – particularly Spain and Belgium – could lead to opposition to Scotland joining the EU for fear of setting a precedent that increases support for those moves towards independence.

This difficulty was acknowledged by European Commission President José Manuel Barroso, who said in February 2014 that it would be "...*extremely difficult, if not impossible*" for Scotland to secure EU membership. This followed an intervention in December 2013 by the European Council President, Herman van Rompuy, where he suggested that the Scottish Government's position of continuity of effect lacked foundation: "*If a part of the territory of a member state ceases to be a part of that state because that territory becomes a new independent state, treaties will no longer apply to that territory.*" Both suggest, therefore, that an independent Scotland would face significant barriers to a smooth and seamless transition to EU membership.

*‘If a part of the territory of a member state ceases to be a part of that state because that territory becomes a new independent state, treaties will no longer apply to that territory’*

**Herman van Rompuy, European Council president, December 2013**

This political situation underlines the fact that, as a country seeking to join a 28 member union, the process of gaining membership will be controlled by the other member states. Even in the case where the Council approved a mandate to begin negotiations with an independent Scotland, the newly independent

nation would face a highly complex negotiating scenario that would need careful diplomatic management in order to achieve the best result for Scotland.

*‘It would be extremely difficult to get approval of all the other member states...I believe it’s going to be extremely difficult, if not impossible’*

**José Manuel Barroso, European Commission president, February 2014**

The white paper does not set out the Scottish government's negotiation strategy with the EU in the event of independence, instead relying on an assumption of continuity of effect. The negotiations cover a number of areas vital to Scottish economic interests – such as public procurement, competition policy, financial services, food and fisheries, and energy arrangements – and uncertainty in how an independent Scotland would go about these negotiations does not inspire business confidence in Scotland's ability to secure EU membership on terms better than currently. Somewhat ironically, the white paper assumes that Scotland can continue to benefit from the UK's deal-making power once Scotland has left the UK. Moreover, there are a number of areas concerning macroeconomic stability where a negotiating strategy is imperative but currently unknown:

- Free movement of people: only two countries, the UK and Ireland, have opt-outs from the Schengen area, with all other EU nations legally obliged to join – joining Schengen would all but rule out a Common Travel Area with the UK and lead to passport controls.
- Currency: the timing for adoption of the euro as Scotland's currency, as mandated in the EU treaties
- Financial stability: details around Scotland's participation in the EU's Banking Union (including any fiscal commitments)
- Financial arrangements: how much an independent Scotland would pay into and receive from the EU Budget
- Transitional arrangements: whether rules are phased in to give current members time to adapt to the new country's presence in the EU (and vice versa).

*‘A region that would separate from a member state of the European Union would remain outside the European Union and that should be known by the Scots and the rest of the European citizens’*

**Mariano Rajoy, Spanish prime minister, November 2013**

Business needs to see a comprehensive plan from the Scottish government for negotiating full membership for an independent Scotland, on terms which are not worse than those currently in place via UK membership.

**Even when membership is secured, it would not be on the same terms as the UK...**

In the long-term, an independent Scotland may join the EU club, but the timeframe by which the Scottish government hopes to achieve EU membership – in time for becoming independent in March 2016 – is highly ambitious. We see it as more likely that the process would drag on for a number of years. Given the need for full approval from both the European Council and European Parliament, it would require very quick political and procedural manoeuvring to

conclude discussions on Scotland's EU membership in the 18-month window between Scotland gaining independence and independence taking hold. The EU legislative process is not renowned for speed and, as identified above, complex legal and political discussions will need to take place. Croatia entered the EU a full ten years after it first applied for membership.

Businesses should therefore prepare for the consequences of a possible interruption to Scotland's EU membership. Any time outside the EU single market would have significant impacts on Scottish businesses' ability to trade. Scottish exports could face tariffs, firms could lose access to global capital and access to foreign markets could be harmed. Even if Scotland were able to join the European Economic Area in the interim, it would be signing up without any influence over the rules of the game. This would mean that Scottish businesses would still have to follow EU rules, but it would remove Scotland's ability to influence those rules by relinquishing the seat at the table in Brussels it currently holds through UK membership.

It is also clear that Scotland will not be able to 'pick and choose' its terms of membership. As described above, an independent Scotland is likely to be asked to commit to joining the euro, the Schengen visa area and play a full part in a Banking Union as a prerequisite to joining the EU. As part of the UK, Scotland currently does not have to be part of any of these. But all new member states are legally obliged to join each – either on entry or with the proviso they do in future – and Scotland would likely have to begin preparations to do so. The reality of Scotland participating in the Euro, Schengen visa area or Banking Union would be travel controls and customs checks on the UK-Scotland border and important issues around the stability of financial centres in Scotland and the rest of the UK.

#### **The importance of effective influence in the EU**

##### ***Increasing financial stability***

The ability to regulate banks' capital requirements at a national level is limited because the global nature of the banking industry allows actors and capital to relocate to less-regulated areas. This risk was in part addressed by the global G20 agreement setting out common global rules of bank recapitalisation after the financial crisis. As the Governor of the Bank of England, Mark Carney, has said, building *"...an open, integrated, resilient system...requires full, consistent implementation of new standards, better information-sharing and co-operation to solve cross-border problems"*.<sup>48</sup>

#### ***Supporting innovation and investment***

A company basing its business model on patented innovations might find it difficult and costly to operate across borders, due to the prohibitive cost and the complexity of obtaining patent protection in new countries. The EU unitary patent, agreed in December 2012 under the enhanced co-operation procedure, will create a single patent system across the EU single market (with the exception of in the non-participating Spain and Italy) and will have a single specialised patent court ensuring the highest review standards. According to the Commission, this could *"...radically reduce, by up to 80%, translation and related costs for obtaining patent protection in the EU"*.<sup>49</sup>

### ...and Scotland must face up to the reality of the influence of Finland in the EU, not Germany

Scotland currently benefits from the UK's ability to influence EU policy on its behalf. The UK has historically influenced right across the EU legislative process to achieve the outcomes it desires, from the genesis of the single market in 1986 to recent British-led progress in Europe on climate change. The need to continue to influence these policy outcomes becomes even more acute when one considers the nature of the modern economy in which many Scottish businesses operate. The challenges businesses face today – and will continue to face in the future – in a global economy are increasingly insurmountable through purely national solutions.

At present, Scotland negotiates in the EU as part of the UK which has the joint largest share of weighted votes in the European Council (29 or 8%) and the third highest number of MEPs (after Germany and France). This formal influence leaves the UK – and therefore Scotland – well placed to use its voting power to further its aims. However, an independent Scotland's population and economy would be roughly the size of Finland's, which has seven votes in the European Council. An independent Scotland would therefore have to accept reduced formal influence in the EU – as indeed would the rest of the UK following the loss of Scottish MEPs and Council votes on independence; another example of where the UK is stronger together.

But the nature of the EU – often consensus driven, often requiring coalitions – means that formal influence alone is rarely the best way to further one's interests. Far from the 'awkward partner' often portrayed, the UK has historically built alliances

across the EU to corral support for its position in areas right across the policy spectrum. In building these alliances, the UK is the preferred partner of the most powerful member states and often functions as a key intermediary between countries. An independent Scotland is unlikely to have the weight to fulfil this role in the same way.

Secondly, having national citizens in prominent positions, both political and official, in EU institutions is an important tool of informal influence. Historically, the UK has been relatively effective in using its representation in the staff of EU institutions, most notably in the Commission, to secure its priorities. For example, the last two UK Commissioners have held prominent portfolios – Trade (Lord Mandelson) and High Representative for Foreign Affairs (Baroness Ashton) – and it is highly unlikely that an independent Scotland would have the clout to secure such high profile appointments on its own, leading to a weaker voice in the College of Commissioners.

Finally, having influence in global institutions can help set the parameters of legislation at a European level in line with one's objectives, especially as the agenda is increasingly being set at an international level to deliver responses to global challenges. The international response to the global financial crisis, and its subsequent impact on EU and UK legislation, highlights this trend. The UK is influential in these international bodies partly by virtue of being a large economy in its own right but also because it is seen as influential in the wider EU. Both of these reasons suggest that an independent Scotland is likely to struggle to be as influential in international forums – and therefore, in the EU – as when it is part of the UK.

This UK influence has not only historically supported Scottish business, but it is a vital tool to achieve the reform in Europe that can drive further prosperity. Scotland is in a much stronger position to push for

#### UK coalition building to achieve an EU budget 'win'

The EU budget negotiations for 2014-2020 highlight the UK's ability to build alliances and achieve clear 'wins' when it engages in the right way. Instead of finding itself isolated, the UK managed to find agreement with other net contributors such as Germany, Sweden, and the Netherlands that there had to be a real cut in overall EU funds in order to reflect significant cost-saving measures that had been implemented at national level by member state governments. In spite of opposition from some net beneficiaries from EU funding, the UK was able to secure an outcome that resulted in a 3.5% reduction of the overall budget in real terms (€960m),<sup>50</sup> compared with the Commission's original proposal which called for a 4.8% increase (€1.025trn) on the previous seven-year period.<sup>51</sup>

#### The business vision for a reformed EU is an EU which:

- Is open and outward looking, signing trade deals with major developed and emerging economies
- Gets the balance right between the EU and its member states, respecting the principle of subsidiarity and protecting access to the single market for non-eurozone members.
- Is focused on driving competitiveness by reducing the regulatory burden and only legislating where strictly necessary
- Continues to exploit its main strength – the single market – by completing the single market in services and sensibly progressing the digital single market.

reform as part of the UK. In *Our global future: the business vision for a reformed EU*, the CBI has set out an ambitious but achievable reform agenda to get the EU focused on driving jobs and growth.

Achieving this for the whole of Europe relies on building influence among member states. UK influence will matter more than ever in the coming years, as the further integration of the Eurozone potentially changes the nature of the EU. The UK must navigate a course that ensures it shapes the EU to preserve the advantages of membership felt by British business. Scotland can have more influence on shaping these advantages inside the UK than by attempting to do so as a smaller independent nation with less formal and informal influence.

### 3 Independence would open key sectors of the Scottish economy to increased risk

In the final section, we look at the implications of independence for five key sectors in the Scottish economy: defence, financial services, energy, higher education and food & drink. All five sectors are major employers. In each, independence would trigger changes to supervisory structures, resulting in disruption for firms used to seamlessly managing their operations across single frameworks within the UK. The consequent upheaval risks putting investment and jobs at risk, with potentially major knock-on effects for the Scottish economy.

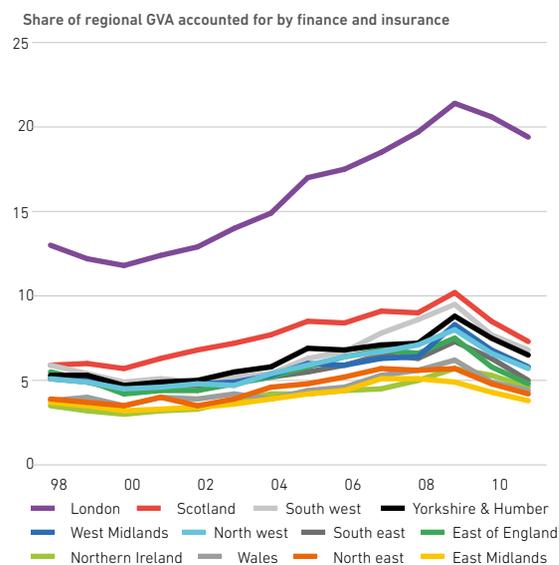
We argue that:

- Financial services firms need a deal that is not on offer at the referendum
- Scotland's defence industry relies on the Union
- The energy market needs an environment that supports long-term investment
- Scotland's higher education institutions are a great resource
- Independence would affect the food & drink sector's ability to promote its products abroad.

#### Financial services firms need a deal not on offer at the referendum

The financial sector makes up a larger proportion of the economy in Scotland than in any other part of the UK except London (**Exhibit 10**). Including banking, insurance, and asset management, it generates £9.24bn of GVA in Scotland. The sector directly employs around 85,000 people in Scotland, with a further 100,000 indirectly employed through related professional services – this accounts for 7% of total Scottish employment.<sup>52</sup> The sector is central to Scotland's future prosperity.

#### Exhibit 10 The proportion of Scotland's economy made up by the financial sector is second only to London in the UK



#### The white paper on financial services

The Scottish government's vision for a vibrant financial services sector rests on protecting a single market between an independent Scotland and the rest of the UK. For this to happen, two key outcomes would be needed post-independence: the creation of a 'sterling zone' and continued Scottish membership of the EU.

The white paper also gives a broad steer on how the prudential and conduct regimes would operate after independence. The prudential regime will be based on the sterling zone, as set out by the Fiscal Commission, with the Bank of England retaining its role as prudential regulator. Finally, an independent Scotland would create a new conduct regulator and enter a jointly operated financial services compensation scheme across the sterling area.

#### CBI analysis: certainty on the internal market and sterling is critical for financial services

The Scottish government's recognition of the critical importance of a single market in financial services is welcome. The white paper rightly focuses on maintaining a stable regulatory environment and access to the EU single market.

Significant uncertainty remains, however, over how this would be achieved in practice. Crucially, the strategy depends on two conditions being met: the creation of a sterling zone and continued Scottish membership of the EU, both of which are highly contingent on future political negotiations and not within the Scottish government's gift.

Beyond this, the white paper leaves a number of key questions unanswered. By providing an isolated view of the sterling zone, the white paper does not address the broader policy and regulatory context for protecting the internal market. For example, while it is proposed that the Financial Policy Committee (FPC) will set macro prudential policy, there is no discussion of the interconnectedness of financial stability, prudential and conduct regulation. Nor is there clarity on the interdependence of key institutions within the regulatory regime. For example, the white paper does not discuss the functions and future working relationship of the FPC and HM Treasury or the wider European system of financial supervision, including the role of the European Supervisory Authorities (ESAs).

In the CBI's view:

- The difficulties faced in securing a sterling zone will create uncertainty and potential extra costs for the financial services sector in Scotland...

...compounded by uncertainty over ensuring Scottish entry to the EU

- Additional costs would also be created if the Bank of England does not play a dual regulatory role, as a new Scottish prudential regulator would be needed...

...and the same is certainly true for a new Scottish conduct regulator

- The white paper provides businesses with little certainty on the basis for future co-ordination between key institutions or on the future of the payments system.

**The difficulties faced in securing a sterling area will create uncertainty and potential extra costs for the financial services sector in Scotland...**

Despite opposition to a monetary union among all the main Westminster political parties, the creation of a sterling zone would be essential for the continued success of Scottish financial services firms to maintain the benefits of the current borderless internal market. Fragmentation of the market between Scotland and the rest of UK is the biggest business worry in this debate. While the white paper attempts to allay fears, many of the future scenarios it envisages are contingent on a sustainable agreement with the UK Government that does not seem to be on the table.

These future scenarios include the creation of a monetary union and continuation of the Bank of England as prudential regulator of Scottish firms. The risk that these outcomes do not happen creates major uncertainty – seen in the arrangements made by some firms to shift business functions away from Scotland in the event of a 'yes' vote.

The top risks of not creating a sterling area:

- Financial products denominated in sterling and held by a Scottish customer with a business headquartered outside of Scotland, and vice-versa, would need to be altered. This would also hamper the ability of firms to serve cross-border clients
- New – and initially shallower – capital markets for the new currency would need to be created. This would either force Scottish firms to borrow in sterling and swap into the new currency or reduce their borrowing – both of which have economic costs
- Scottish annuities would in all likelihood be backed by assets that share similar characteristics to the annuities in terms of currency denomination, duration and inflation protection. Annuitants may face higher costs if any of following apply: Scottish gilts are in shorter supply, Scotland is not in a sterling zone, indexed gilts are not available matching Scottish rates of RPI or CPI.

**...compounded by uncertainty over ensuring Scottish entry to the EU**

The second condition on which the white paper's vision for Scottish financial services is based is continued membership of the EU. Again the CBI agrees that uninterrupted access to the EU's single market is crucial for continued success. The ability to passport services across the continent is of huge benefit to Scottish financial services firms. Like the creation of a sterling area, however, continued membership of the EU is not certain.

The top risks from Scotland not being an EU member:

- Scotland would be required to negotiate new trade agreements with the EU and other countries – and while these are completed there would be considerable uncertainty. Unilateral trade deals may also result in less favourable terms
- Scottish firms may have to comply with third country rules and would lose the ability to passport services to EU member states
- To access the EU's single market, financial services firms would likely relocate away from Scotland.

**Additional costs would also be created if the Bank of England does not play a dual regulatory role, as a new Scottish prudential regulator would be needed...**

The regulation and supervision of the financial system cuts to the heart of how to run a successful monetary union. Bank of England Governor Mark Carney recently outlined a number of conditions which must be met and operating a banking union is a key. This would include: common supervisory standards, access to central bank liquidity and lender of last resort facilities, common resolution

mechanisms and a credible deposit guarantee scheme. All of these also require at least a degree of fiscal integration to function well. The problems which this integration would present for an independent Scotland in terms of fiscal oversight are outlined above. While the white paper sets out the Scottish government's vision for the Bank of England to provide common supervisory standards, liquidity insurance and lender of last resort facilities, it does not outline in any detail plans for a common resolution framework or deposit guarantee scheme.

The top risks from not having a single prudential supervisor:

- Scotland would need to create a new regulator to comply with EU rules. This regulator would have to transpose existing EU directives into national law – this would create a great deal of uncertainty and transition arrangements would be needed
- With separate regulatory regimes there would inevitably be divergence, especially as new EU directives are implemented. This would further fragment the UK internal market and increase compliance costs for businesses operating cross-border.

The top risks from an incomplete banking union:

- Insufficient resolution arrangements for large banks could lead markets to price-in additional risks against the credit-worthiness of a Scottish sovereign
- Disagreements over the functioning of a deposit guarantee scheme would increase uncertainty for depositors.

The strategy set out in the white paper views these changes in isolation and does not provide context to how they can be made in practice. It is important to remember that central bank functions, currency union, financial stability and prudential regulation are interdependent and all subject to EU legislation.

#### **...and the same is true for a new Scottish conduct regulator**

The white paper sets out plans for the creation of a new Scottish conduct regulator to replace the FCA in Scotland. While the added clarity on the arrangements for conduct regulation is welcome, important questions remain unanswered.

The top risks in creating a separate conduct regulator:

- With the introduction of new rules for individuals (senior persons regime and licensing regime) there is significant uncertainty about how an equivalent regime would be implemented in an independent Scotland. If an equivalent regime is not implemented, this could have an impact on the movement of talent between Scottish regulated firms and firms regulated in rUK

- Dual regulators will necessarily increase the compliance costs for firms servicing customers in both nations, even if both regulators strive for convergence
- Any new Scottish regulators would require funding from the Scottish Government or an additional business levy, including the Scottish equivalent of the FCA, the Pensions Regulator, the Pensions Protection Fund, the Pensions Ombudsman, the Money Advice Service, the Pensions Advisory Service, the International Pensions Centre, the Financial Services Compensation Scheme, the Citizens Advice Bureau, and Competition & Markets Authority
- Differing judgements on product suitability may impact the types of products and services available in each jurisdiction, which could reduce the choice of products and services available to customers
- The establishment of a new regulator would create widespread uncertainty about its approach to ongoing issues including:
  - reviews including pensions sales review, mortgage endowments complaints and mis-selling (including PPI and interest rate hedging products)
  - provisions for client money and assets protection
  - service intervention powers
  - the regulation of information provided to retail consumers
  - dispute resolution arrangements.

#### **The white paper provides businesses with little certainty on the basis for future co-ordination between key institutions or on the future of the payments system**

A key omission from the white paper is how the payments system will be managed post-independence. The payments system provides the financial 'piping' that supports almost all economic activity in the UK. Currently owned and operated by the UK's major banks, the payment system is set to come under FCA regulation in April 2015. However, with the white paper setting out the creation of a Scottish conduct regulator, the future supervision of the payments system remains in doubt.

Lack of clarity about future access to the payments system may force firms to relocate away from Scotland.

### The white paper on defence

The white paper outlines a broad vision for the potential future of defence in Scotland. A slimmed-down defence force would initially be equipped with, and housed in, a potential £7.8bn worth of assets transferred to Scotland after negotiations with the MOD. These forces and assets would be sustained and upgraded by an annual defence budget of £2.5bn. Where possible, this budget would be spent with the Scottish defence industry. In addition, the white paper anticipates the prosperity of Scotland's defence industry would be maintained through ongoing contracts with rUK, overseas trade and diversification into other activities.

### Scotland's defence industry relies on the Union

There are 185 defence companies operating in Scotland employing over 12,600 people, according to Scottish Development International.<sup>53</sup> Furthermore, the UK Ministry of Defence's (MOD) prime contractors – defence firms but also other support services – employ over 14,000 people in Scotland.<sup>54</sup>

### CBI analysis: the white paper is unclear on critical aspects of future viability for an independent Scotland's defence industry

In particular, the CBI has concerns that:

- The process of transition towards independence would expose the Scottish defence industry to potentially damaging levels of uncertainty and risk
- Low levels of domestic defence spending would erode competitiveness, leaving the industry vulnerable
- The lack of a credible exports or support plan in the white paper leaves questions over the industry's sustainability post-independence.

### The process of transition towards independence would expose the Scottish defence industry to potentially damaging levels of uncertainty and risk...

In the event of a yes vote, a 'transition' period is expected while the Scottish government not only negotiates with the MOD over the division of UK assets, but also sets up its own domestic defence institutions and regulations. The length of this transition period is unclear. Moreover, there can be no guarantees as to what the outcome of these complex negotiations would be – outcomes that would necessarily shape future Scottish defence procurement requirements and indeed those of rUK.<sup>55</sup>

This uncertainty would be compounded by the broader fiscal uncertainty arising from independence (discussed earlier in this paper). In addition, the UK government has clearly stated that an independent

Scotland would not be eligible to bid for sensitive rUK defence contracts.<sup>56</sup> Defence companies in Scotland would have no choice but to question the value of their existing contracts, sales pipelines and strategic plans.

Companies providing defence support services in Scotland would also be affected. While some may choose to diversify their businesses post-independence as the white paper suggests, this amounts to a tacit admission that Scotland's defence industry may well shrink in the process.

### Low levels of domestic defence spending would erode competitiveness, leaving the industry vulnerable

While independence might produce some domestic defence procurement opportunities for Scottish suppliers, problems of scale, capability misalignment and above all customer affordability would mean these opportunities are unlikely to be realised.

In addition to inherited assets, the white paper outlines a defence development plan that includes the procurement of new ships and aircraft and the repurposing of existing MOD facilities such as HMNB Clyde. More than 6,500 service and Civilian personnel are employed at HMNB Clyde at present, and while the white paper envisions that Faslane will be the base of the new Scottish naval force and joint command, it is unrealistic to assume employee numbers will be similar, given the fundamentally different purpose of the base in that scenario and lower spending from the Scottish government.

The huge costs of procurement programmes would have to be met alongside operating costs of the service and maintenance of existing assets and facilities. All of this would have to fit within an anticipated annual defence budget of around £2.5bn (compared to a UK spend of over £31bn in 2012-13, excluding operational costs).

With planned equipment procurement spending in the UK making up about 20% of total spend for the period 2012-22,<sup>57</sup> a similar proportion of spending in an independent Scotland would equate to only £500m a year. A spend of this order would necessarily greatly reduce the intensity of an already limited pipeline of proposed Scottish defence procurement. It would deprive Scottish industry of a steady domestic order book, compromising its ability to invest in R&D and deliver cost savings based on economies of scale.<sup>58</sup>

Furthermore, the Scottish defence industry would be likely to capture only some of the value of the domestic procurement opportunities available. Because of its maritime predominance,<sup>59</sup> the Scottish defence industry would struggle to capture the full value of aerospace and land manufacturing contracts.

The impact of a relatively low-value, low-intensity domestic procurement pipeline would be to leave the Scottish defence industry less competitive while simultaneously making it more reliant on international trade to remain sustainable.

#### **The lack of a credible exports or support plan in the white paper leaves questions over the industry's sustainability post-independence**

Given the scale of the likely challenge, the Scottish Government's vision for how it would help maintain and boost export levels by Scotland's currently world-class defence industry is inadequate. That has obvious implications for its long-term sustainability.

Plans to access potentially large markets – which the Scottish government aims to do via membership of the EU or through bilateral security arrangements – carry great uncertainty. Its plan to continue working on major UK defence projects such as the Type 26 Frigate or the Successor Class submarine, expected to be worth tens of billions and last for decades, has already been denied. Any bid opportunities available for rUK contracts would be subject to international competition, and it is likely that the UK government will favour warship construction and maintenance for the royal navy remaining in the UK – the same process that currently aids Scottish sites will start to work against them. Moreover, questions around how an independent Scottish government would support industry R&D – work that would play a pivotal part in maintaining a Scottish defence industry's international competitiveness – remain unresolved in the white paper.

This lack of clarity is in stark contrast with existing UK schemes and supporting infrastructure. Scotland currently benefits from an established network of support from UKTI and the UK Export Finance scheme, direct MOD investment in industry R&D worth £400m annually, a generous R&D tax credits regime, and ongoing collaboration between industry and government as part of the UK's Defence Growth Partnership. All of this suggests the Scottish defence industry would benefit from Scotland remaining part of the Union.

#### **The energy market needs an environment that supports long-term investment**

The energy sector is a key driver of the Scottish economy.<sup>60</sup> Around 200,000 people are employed directly or indirectly in the oil and gas sector across Scotland while the renewables sector is thought to account for around 11,695 full-time jobs.<sup>61</sup> The renewable projects announced between April 2010 and January 2013 are expected to create 9,000 jobs and £13bn of investment in Scotland alone.<sup>62</sup>

#### **The white paper**

The white paper recognises the paramount importance of continuing the single Great Britain (GB)-wide market for gas and electricity but proposes the creation of a separate Scottish regulator. It suggests bill payers in an independent Scotland and rUK would continue to share the costs of support for renewable energy generation and transmission (the Scottish government has set a target of delivering the equivalent of 100% of electricity demand from renewables by 2020). On oil & gas, it says Scotland would seek to maximise production and pursue a supportive tax regime while also recognising the importance of having a coherent decommissioning regime. And it commits to making Scotland 'nuclear-free'.

#### **CBI analysis: The energy sector is one of the major components of the Scottish economy and confidence about the future is essential for long-term investment**

In particular, the CBI has concerns that:

- The benefits of a UK-wide approach to energy policy, with shared costs reflecting shared challenges, could be at risk
- Independence would create new regulatory structures that increase costs...  
...and could lead to a fall in demand for Scottish-generated power as rUK seeks the cheapest sources of energy.

#### **The benefits of a UK-wide approach to energy policy, with shared costs reflecting shared challenges, could be at risk**

A UK-wide approach to energy policy reflects the magnitude of addressing the central shared challenges facing the UK today: affordability for consumers, decarbonisation and a balanced energy mix, and security of supply. A single regulatory approach across the UK helps to deliver efficiency, reduces costs, creates economies of scale and ultimately provides value to consumers. These shared benefits could be put at risk by Scottish independence.

The current single market for gas and electricity allows power to be generated, transmitted and distributed across Great Britain in the most efficient and effective way possible – this approach is good for businesses and domestic consumers, keeping costs down. Between 2009 and 2012, 13.6% of UK electricity generation took place in Scotland, with England accounting for 76.5%, Wales 7.9% and Northern Ireland 2.1%.<sup>63</sup>

The costs of decarbonisation are also shared throughout the GB market. Under the current system, the costs of subsidising renewable energy are spread across consumers in Great Britain, ensuring that the costs of producing cleaner energy remain manageable whilst providing an incentive for businesses to invest in new technologies. Reflecting the fact that Scotland accounts for around a third of the UK's renewable electricity generation today, around 30% (c. £500m) of the total value of the Renewables Obligation (RO) – the main support mechanism for UK renewable electricity projects – goes to Scottish-based generators.

In addition, the commercialisation of Carbon Capture and Storage (CCS) has the best chance of success if the UK pursues a joined-up approach that spreads costs across the constituent parts of the UK for the benefit of all. The CCS Commercialisation Competition, run by the Department for Energy and Climate Change, has earmarked £1bn to demonstrate CCS, while a further £125m is available for CCS R&D and innovation. As part of this competition, the UK government announced millions of pounds of funding in February 2014 for a joint Shell/SSE CCS project at the Peterhead power station in Aberdeenshire, which will be the first commercial-scale gas-fired CCS plant.

#### **Independence would create new regulatory structures that increase costs...**

The white paper states that an independent Scotland would create its own regulator looking at gas and electricity markets. This would mean two separate regulators within the GB market, with two different governments pursuing potentially different policy objectives. Such differences appear inevitable – for example over the role of nuclear power which is opposed by the Scottish government but supported by the UK government.

There are serious unanswered questions as to how these regulators would work together and how political differences would be handled. Divergent regulatory approaches could undermine the benefits of a single market, pushing costs up for consumers.

On oil & gas, a single framework invariably promotes efficiency by reducing the regulatory burden and compliance costs, based on a single and consistent approach throughout the UK Continental Shelf (UKCS). By ensuring that businesses follow one health and safety regime, are subject to one tax regime and one licencing regime, operators can take a broader view of the UKCS and focus on maximising resource recovery. The current framework may be undermined if independence leads to divergence to meet different energy goals in Scotland and rUK.

While this might not have a serious impact on oil recovery as the vast majority of reserves lie in Scottish waters, gas reserves are spread more evenly, with around 40% of UK gas reserves thought to be in rUK waters.<sup>64</sup> A divergent approach here would likely push up compliance costs for the UKCS as a whole, as companies would be forced to act in accordance with different regimes in Scottish and rUK waters.

Consistency in the decommissioning regime is also vital to the on-going success of the UKCS. The Scottish government's paper *Maximising the return from oil and gas in an independent Scotland* suggests that the cost of decommissioning is around £36.7bn (2012 prices) over the period to 2050.<sup>65</sup> HMRC estimated that this would cost government £20bn (2011 prices) in relief against the petroleum revenue tax and corporation tax.<sup>66</sup>

The white paper's commitment to guarantee financial support for decommissioning through the tax system at the same level as currently provided by the UK government is welcome. But it also suggests that a contribution towards this would be sought from the rUK government. But if such an agreement was not reached, the costs of the regime would need to be met by an independent Scotland, with clear implications for its public finances.

#### **...and could lead to a fall in demand for Scottish-generated power as rUK seeks the cheapest sources of energy**

Power generated in Scotland would continue to be supplied to the rUK in the event of independence, given that the UK is currently an open market with interconnections to other countries. In all, Scotland exported 26.1% of the electricity it generated to consumers in the rUK in 2012 and 2011.<sup>67</sup>

It should not be assumed, as the white paper suggests, that the cost of subsidising renewable generation would continue to be met by consumers in rUK because, in an open market, rUK would be likely to seek the most cost-efficient energy mix. Furthermore, rUK may be reluctant for consumers to help meet the increased transmission and infrastructure costs that accrue from Scotland's challenging geography and relatively low population density. This could put at risk schemes such as the Hydro Benefit Replacement Scheme, which keeps costs down for consumers in the north of Scotland.

### Scotland's higher education institutions are a great resource

Scotland has a world-leading higher education sector, with five universities in the world's top 200.<sup>68</sup> This stature is demonstrated by the number of students in Scotland rising to a record high of 27,990 in 2013.<sup>69</sup> According to Universities Scotland, the sector employed 34,603 staff in 2011.<sup>70</sup> Scottish universities are successful in driving forward pioneering research, in particular in partnership with the private sector,<sup>71</sup> and they play an essential, dynamic role in the Scottish economy.

**CBI analysis:** The white paper recognises the importance of the higher education sector to the Scottish economy. Despite this, the proposals risk disrupting research partnerships and access to university places.

Recognition by the Scottish government of the strong role played by the higher education sector is welcome. But independence could have a far greater impact on the sector than the white paper acknowledges.<sup>72</sup>

In particular, the CBI has concerns that:

- Plans to make students from the rUK pay for tuition fees may not stand up to legal scrutiny
- An independent Scotland would face barriers to undertaking research with rUK under international rules.

#### Plans to make students from the rUK pay for tuition fees are unlikely to stand up to legal scrutiny if Scotland joins the EU

There are real questions as to whether the Scottish government's proposals to make students from the rUK pay for tuition fees, while ensuring free placements for other EU members, would stand up to legal scrutiny. It is likely that the Scottish government would have to achieve their inclusion in the terms of accession to the EU for this to continue, which is an unlikely scenario given the unanimity required to allow a new member into the EU.

If that policy is overturned, there is a potential £150m price tag for treating students from the rUK the same as those from elsewhere in the EU.<sup>73</sup> The Scottish Government needs to clarify how it would make up this funding shortfall if its plans to enforce the status quo are deemed inappropriate under EU law.

#### An independent Scotland would face barriers to undertaking research with rUK under international rules

The white paper expresses a wish to maintain shared research arrangements. That is not surprising. Scotland currently benefits from a common and consistent framework which allows funding and talent to flow freely across the Scottish border to the benefit of all parts of the UK. Under international rules, an independent Scotland would face barriers from undertaking research with rUK, rather than as part of a United Kingdom. Over time different regulatory regimes would be likely to deviate, causing potential delays and the erosion of collaborative relationships. Issues like the contribution that an independent Scotland would have to make to CERN, the future of TSB work in or of use to Scotland and support for Scotland's high level of university spin-out companies would all have to be addressed.

More tellingly, rUK is likely to wish to spend any shared research budget in proportion to the population or economic size of the two countries. Scottish universities currently receive 50% more in research grants from the UK research councils than they would if allocation of funding was based on population share.<sup>74</sup> There is a similar, slightly smaller, overspend in Scotland when research spending is compared to GDP – Scotland receives 13% of research spending for 8% of the economy. Given this, the white paper fails to address how the Scottish government proposes to make up for the potential shortfall. Scotland is at the leading edge of research with the partnership of UK research councils, and this can be maintained by agglomeration, not separation. The Witty Review was clear about the need to build on the specialisms of Scottish universities.

#### The white paper on higher education

The white paper argues that an independent Scotland would work to support the higher education sector and encourage both academic staff and students from around the world to study in Scotland, contributing to the economy and wider society. To help achieve this, the right to education for all would be enshrined in the new Scottish constitution.

After independence, Scottish domiciled students would continue to have free access to higher education, with a set number of places provided by the Scottish Funding Council.

It is proposed to continue the current status quo of charging students from the rUK to study at Scottish universities. This would be to ensure that Scottish students were able to maintain access to the limited number of places. Access for students from elsewhere in the EU would continue to be supported and the Scottish government believes that these policies would be consistent with EU requirements.

The white paper confirms the importance of a strong research environment and voices support for maintaining the current 'common research area' with the rUK, sharing research councils, access to facilities and peer review.

It is clear that the Scottish higher education sector possesses great strengths. Given the uncertainties posed by independence to the security of its funding and regulatory regimes, however, the CBI believes the sector's continued success would be best assured as part of the UK.

### Independence would affect the food & drink sector's ability to promote its products abroad

Scotland has a substantial food and drink industry, supporting over 300 companies generating 333,000 jobs and a sector turnover of £12.4 billion.<sup>75</sup> Scotch whisky alone accounted for 80% of Scottish exports in 2013.<sup>76</sup> Farming, fishing and aquaculture also contribute significantly to the Scottish economy, with Scottish salmon being exported to over 60 countries.<sup>77</sup>

#### The white paper on food & drink

The white paper highlights the importance of the food and drink sector to the Scottish economy, in particular agriculture, aquaculture and drinks exports. The success of whisky and farmed salmon are used to demonstrate the growing strength of Scottish products in emerging markets.

According to the white paper, independence would raise Scotland's international profile, delivering new opportunities for food and drink based exports. The paper also claims Scotland would achieve better overseas representation as an independent nation, using this new stature as a powerful tool for tackling barriers to trade and a perceived lack of focus on Scottish goods from UK-wide trade institutions.

An independent Scotland would retain the income from its food and drink sector to reinvest in promotion of its produce and would continue cooperation with the rUK on research and other related issues.

**CBI analysis:** The white paper rightly cites the strength of Scotland's food and drink industry. Independence would cause serious uncertainty about Scotland's access to the rUK and European market, as well as Scotland's ability to promote its products abroad.

In particular, the CBI has concerns that:

- Scotland would lose the benefits of the UK's trade infrastructure...

...and of UK defence of Scottish agriculture in the EU, including access to EU funding support.

#### Scotland would lose the benefits of the UK's trade infrastructure...

Scotland's food and drink industry currently benefits from the significant trade infrastructure of the UK, both at home and abroad. For example, the UK has recently lobbied Russia and China for action on counterfeiting and accurate geographical indicators on whisky products.

In addition, as outlined elsewhere, Scotland already benefits from access to the world's largest single market through the UK's membership of the EU. This is a big contributory factor to the success of Scotland's whisky industry in particular, with exports of whisky to the 26 other EU countries accounting for £1.45bn in 2012 alone.<sup>78</sup>

Given the uncertainty about Scotland's accession to the EU as an independent country, any time outside of the single market may put these exports at risk. The erection of an international border between Scotland and the rUK would also raise questions over Scotland's significant exports to England, Wales and Northern Ireland, given the potential disruption to established trade relationships in the event of independence.

#### ...and of UK defence of Scottish agriculture in the EU, including access to EU funding support

Scotland benefits from being part of the world's sixth largest economy, with the international clout and bargaining power that brings. Whether it is access to the EU or promoting Scotland in emerging markets, the Scottish food and drink industry benefits from being part of the UK and its open, globally focused trading environment.

Britain has been active in defending the interests of Scottish agriculture, lobbying for reform of the Common Agricultural Policy to better support Scottish and rUK farmers.<sup>79</sup> The capacity of an independent Scotland to press these interests would depend both on its membership of the EU and its ability to gain a hearing as a relatively small economy. As highlighted earlier in this paper, an independent Scotland would be likely to have less influence in the EU than the UK currently does.

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*The Scottish government's plans for independence*