Speech
Speech by the Permanent Secretary to the Treasury: The Treasury and the Union

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This speech, delivered to the Strand Group, part of the Policy Institute at King's College London sets out Nick Macpherson's personal reflections on the relationship between HM Treasury and the Union, both historically and more recently.

2014 was an extraordinary year in the 307 year old union between England, Wales and Scotland.

The Scottish people voted by an 11 percentage point majority to stay in the United Kingdom. And in November the main political parties, under the chairmanship of Lord Smith of Kelvin, agreed to devolve tax raising powers to the Scottish Government on an unprecedented scale.

At the same time, the economic and monetary union between the countries of the UK has been reaffirmed. The UK remains one of the most enduring single markets in modern history, based on a single currency, a single fiscal policy, a free trade area and a social union based around a solid pillar - a retirement pension based on a single national insurance system.

Today, I want to set out the Treasury's historic role in financing the countries of the UK before going on to its more recent contribution to the Independence Referendum and the Smith Commission.

<u>Treaty of Union</u>
I shall start with the Treaty of Union itself.

The Treaty of Union's antecedents have given rise to many myths. I don't intend to explore them today. As Keith Robbins has put it "*the treaty was an act of state negotiated and concluded, naturally, by political elites on both sides. It might, or might not, be a settlement to which 'hearts and minds' gave their assent. There is no way of judging what popular opinion, north and south of the Border, felt in detail about the issues"*[1]. What is clear is the deal which underpinned the Treaty, and Acts of Union, suited the elites of both countries. The Scottish Parliament endorsed the Act by 110 to 67, a clear majority, and voted itself out of existence in the process.

Godolphin, the last but two of the Lord High Treasurers (supplanted for good by the Treasury Board in 1714), led negotiations for the English. To that extent, the English Treasury was at the heart of the negotiations. The Scottish leadership was more diffuse. And allegiances shifted through the discussions, not least because of the important role of the Scottish Presbyterian church and its understandable concern that England might seek to reimpose bishops and Anglicanism and undermine the role of the General Assembly.

However, the final settlement was dominated by economic issues, above all trade. The Scottish elite had only recently sought to compensate for their lack of access to new English markets in North America by seeking to create its own colony in what is now Panama. The disastrous Darien scheme was the brain-child of that interesting chancer, William Patterson, who helped found the Bank of England in 1694. The Darien scheme wiped out the Scottish elite financially and consigned many of the colonists to unpleasant and untimely deaths.

Article IV of the Treaty of Union provided for "Freedom and Intercourse of Trade and Navigation" – in short free trade not only within the United Kingdom but with its emerging colonies.

Article XV provided for the "Equivalent" which effectively compensated the Scots for taking on their share of England's national debt – at that time inflated by the war with France. The sum of £398,000, some £66 million in today's prices, was paid to Scotland, much of which was used to compensate investors in the Darien Scheme[2].

Article XVI provided “That from and after the Union the Coin shall be of the same standard and value throughout the United Kingdom as now in England”: in effect creating an economic and monetary union through the adoption of the pound sterling, under the auspices of the Treasury and the Bank of England.

The Treaty embedded the principle that Scotland was different when it came to fiscal matters, providing for “the encouragement of the manufacture of coarse wool in certain Scottish shires, and such thereafter to the promotion of fisheries.” When free trade rendered such state aid redundant in the 19th century, the grant was redirected towards education in the fine arts, “essentially the National Gallery for Scotland and the Museum of Antiquities”[3]. And while the Act of Union reaffirmed that the four ancient Scottish Universities “shall continue with this Kingdom for ever”, they also benefited from an annuity which by 1817 had reached £6000 a year. As Ian Levitt points out, there was no such public funding for the two English universities.

Goschen and Barnett

However, for much of the 18th and 19th centuries, the Treasury’s influence on Scotland was small, mainly because public spending was largely about war and the interest paid on debt to finance it. There was the occasional exception: Charles Trevelyan, then an assistant secretary at the Treasury, was put in charge of dealing with the Highland Potato Famine. In 1846, he wrote of the Highlands: “the people cannot, under any circumstances be allowed to starve”. In this respect it is possible to detect a different Treasury attitude[4] towards Scotland from Ireland where Trevelyan could describe the famine as a “calamity [sent by God] to teach the Irish a lesson” and an "effective mechanism for reducing surplus population.”

The gradual extension of the state from the late 19th century and the creation of the Scottish Office in 1885, a strong advocate for additional spending north of the border, posed deeper questions around funding for Scotland. A good example of additional intervention was the debate about increased subsidies to MacBraynes for the Strome-Portree and Strome-Stornoway ferries, which came to a head with an increased subsidy of £1900 a year in 1887. Goschen, the then Chancellor, was a

Liberal Unionist who was keen to maintain Liberal Unionist support for a Conservative-led Government. (There are echoes of Goschen's decision in some recent announcements such as reduced VAT on ski lifts and reduced fuel duty in remote areas).

However, it was the Goschen formula which was to have rather greater long term implications for the financing of Scotland. Its aim was to relieve ratepayers of some of the burden of local expenditure – in effect, a prototype revenue support grant. And in the case of Scotland, it became an important means of financing education. The Goschen formula allocated the proceeds of the wheel tax and horse tax and half of the revenue of probate duty, to England, Scotland and Ireland according to ratios of 80, 11 and 9 per cent. From a revenue perspective, Goschen argued that "this division [gave] Ireland the benefit of the doubt to the poorer country". However, it was a poor deal relative to Ireland's population[5].

From a Scottish perspective, the Goschen formula was fair both on a revenue and population basis, though over time slower population growth in Scotland ensured it would become a beneficiary of the formula. But Goschen's impact was limited, not least because in the era before the welfare state expenditure on "imperial services" – defence and debt interest in particular – still accounted for the bulk of public spending.

Analysis by the Kilbrandon Commission and the Treasury's needs assessment study of 1979 suggest that as late as 1959 Scotland's public expenditure per head was only marginally above England's. But by 1970 it was some 30 per cent higher. As Professor McCrone has argued this might "*be due to some sort of delayed effect of the Goschen Formula….but it was probably, in part at least, also a consequence of undertakings in the White Papers of 1963 and 1965 on Scotland and the North East of England…to promote economic development and [which] explicitly pledged that infrastructure investment would be above population share*"[6]. It was certainly an era when secretaries of state were successful in making the case for Scotland's special needs "such as sparsity of population in the remote areas[7] and density and poor housing in the central belt". And it was the time when industrial policy reached its most interventionist. This was still in place when I was a young Treasury official advising on regional selective assistance in the mid-1980s. Whether this more activist industrial policy had any effect is open to doubt: certainly that great historian of the Treasury, George Peden, has noted that the improvement in Scotland's economic performance from the late 1980s coincided with a period when "government assistance to industry in Scotland was about a quarter of what it had been ten years earlier".[8]

By the mid-1970s, the Treasury had a more generalised public spending problem. And the Barnett formula was very much of its time. "In essence, Barnett was an update of Goschen, but with the distinguishing feature that instead of quantifying the annual per capita spending increase as a percentage of the Scottish baseline it was granted instead as a cash figure per capita, derived from the percentage increase granted to the (lower) English baseline. In other words, if England received say, a 4 per cent increase per capita which amounted to £1000, Scotland would receive £1000 per capita although that would be less than 4 per cent of the (higher) Scottish baseline. This new arrangement injected into the process the concept of gradual convergence".[9]

The eponymous author of the formula never saw it as a permanent solution. "I thought it might last a year or two before a government would decide to change it. It never occurred to me for one moment that it would last this long". Like many of the Treasury's best and most debated formulae, it has never quite had the impact intended – partly because of deals outside the formula and partly because in its early years population changes were not adequately reflected in the formula's annual update. It is arguable that this tended to benefit Scotland at the expense of the rest of the UK.

Barnett anticipated a devolution settlement which never happened.

When it did, the funding formula remained in place: not because there weren't people in London and Scotland who couldn't see a better way forward but in the absence of consensus the status quo was always likely to remain in place.

The strange thing about the 1998 settlement was how little it changed things fiscally. Of course, the Scots had the variable rate of income tax but successive administrations - some unionist, some nationalist - chose not to exercise it.

Indeed, the 1998 settlement pretty much perpetuated economic arrangements which had been in place since 1885. Of course, democratic accountability had changed. The civil servants in St Andrews House in Edinburgh were accountable to a democratically elected Scottish Government rather than the Secretary of State for Scotland, but the proportion of tax determined locally remained small, relative to, say, the federal systems in the US and Germany.

Of course, the Smith Commission's proposals, which themselves built on the work of the Calman Commission[10], have changed all that.

Independence debate

But this was not before a much wider debate over whether Scotland should be independent and what independence would mean.

The experience of a country leaving the union is nothing new. The Irish Free State came into being in 1922, albeit in different circumstances. The Free State was born of violence rather than the ballot box. The Act of Union of 1800 never had the same legitimacy as that of 1707. The Irish economy was always smaller than Scotland's, and Ireland did not have the natural resources that Scotland has.

Nevertheless, the Irish experience did provide some historical pointers. Although the Irish authorities were able to peg the Punt to Sterling for a long period, they never sought or were offered a formal currency union. The trade war in the 1930s suggested it was difficult to maintain a single market. And the 10 per cent cut in the old age pension in Ireland in 1924 confirmed that a social union was difficult to maintain in the absence of full political union – notwithstanding that King George V was still Head of State at the time.

I don't intend to re-rehearse all the arguments of last September's referendum. I don't claim to be an expert on foreign or defence policy, or for that matter immigration or security policy, though it is striking that the Treasury coordinated all the work which set out the case for the Union. Why the Treasury, rather than the Cabinet Office or Scotland

Office? Partly, because the Treasury has the analytic capacity necessary to lead a project such as this. Partly, because of previous experience. It is no coincidence that Sir David Ramsden led the work on the 5 Economic Tests on the Euro in 2003, and also played a leading role in the Scottish Analysis programme. But mainly because the Chief Secretary and Chancellor were determined to play a leading role in the Referendum Campaign, and - cohesive organisation that the Treasury is - officials were quick to respond.

The Scotland Analysis programme was an extraordinary logistical feat. Some 15 papers were produced running to 1400 pages. 8 departments contributed. The project was run by a standing Treasury team of six officials, though during the course of two years' work some 50 officials contributed to the analytic work: some briefly, others on a more sustained basis.

Our analytical papers had a strong recurring conclusion. Of course, small countries can have very successful economies, providing they pursue the right policies – the experience of Ireland over the last 50 years bears that out – but the fact is being part of a large, integrated domestic economy has very significant economic advantages for Scotland.

Going back as far as data will allow, Scottish economic growth per capita has outperformed the UK average. Over the past 50 years, economic growth per head in Scotland (2.2%) has been slightly stronger than in the UK as a whole (1.9%). As part of the UK, Scotland has the highest employment rate of all nations in the UK, and is higher even than America.

Let me explain the Treasury's position on what to me were the four most important economic issues: trade, financial services, fiscal policy and currency.

<u>Trade</u>

First, going back to Gladstone, the Treasury has always celebrated the benefits of free trade, itself influenced by those heroes of the Scottish enlightenment, David Hume and Adam Smith. And so it is hardly surprising that the Treasury saw the emergence of a border as a threat to Scottish and British prosperity. Our analysis confirmed that the high levels of trade between Scotland and the rest of the UK had been strongly facilitated by a highly integrated economy.

Scotland trades more with the rest of the UK than it does with the rest of the world. 70% of Scottish exports go to the rest of the UK, whereas just 10% of the rest of the UK's exports are with Scotland. The freedom to trade goods and services across the UK supports greater productivity through knowledge sharing, specialisation and economies of scale.

A separate Scottish state would have had to establish its own macroeconomic and institutional framework. Divergence between Scotland and the continuing UK would have led slowly but inexorably to a weakening of economic integration, as has been the case with the Czech Republic and Slovakia.

Of course, goods would still have been traded across the border, just as they are between the Republic and Northern Ireland. But international evidence shows that flows of trade, labour and capital are much larger between two regions of the same country than between two (otherwise similar) regions of two different countries.

Outside of the UK, Scotland's trade performance would also have hinged on the terms Scotland negotiated for rejoining the European Union. How long Scotland would have taken to rejoin, and – crucially - under what conditions, would have depended on negotiation with and the agreement of all other EU states. And this in turn raised interesting wider questions about whether Scotland could have secured a rebate on its contribution to the EU budget, and whether it could avoid any commitment to join the Euro.

<u>Financial services</u>
The importance of free trade is perhaps greatest when it comes to financial services, one of Scotland's most dynamic sectors over the last thirty years.

Scotland's financial sector has benefited from being part of a large fiscal and economic union. It supports – directly and indirectly - more than 200,000 jobs in Scotland – more than 8 per cent of Scottish employment. The Scottish financial services industry has estimated that nine out of ten of its customers for many products are located in other parts of the UK.

Being part of the larger UK market gives regulators, firms and individuals confidence in managing funding and financial risk across a larger population. Greater competition provides customers across the UK with a greater choice at a lower cost. For all the efforts to create a single market in services, cross-border sales of financial products are limited. And where markets are smaller, they tend to become more concentrated.

International investors value the fact that large financial firms based in Scotland are part of the UK-wide regulatory framework. This single regulatory framework could not have continued if Scotland had become independent.

The Scottish banking sector would have been exceptionally large compared to the size of an independent Scotland's economy, making it more vulnerable to financial shocks. As I saw at first hand as Alistair Darling's Permanent Secretary, the Treasury was able to support the large Scottish banking sector during the financial crisis, but this was only possible due to the scale of the UK, the strength of UK institutions and the UK's credibility in financial markets.

And this was not just Treasury assertion. A number of leading firms made their contingency plans clear in the run up to the referendum, including the large banks. Had Scotland voted for independence, there can now be little doubt that these firms would have moved their head-quarters south of the border. How much economic activity would have gravitated south is difficult to tell. But a reasonable surmise is that, given the currency risk, the Scottish financial sector would have become increasingly focused on the Scottish market, reversing the trend of the last three hundred years for Edinburgh to be an international centre.

<u>Fiscal</u>

The public finances inevitably were a strong focus of the Treasury's Scotland analysis work. Here, there were three issues.

What was the public finance baseline which would inform independence? And what were the likely long term trends on revenues and spending?

The question of the baseline was an important one, since North Sea revenues have been on a downward trend for some time. And so how an independent Scotland's public finances would look relative to the rest of the UK in, say, 2016-17, the putative year of independence, was likely to be very different from 2012-13 – the last year for which detailed data were available.

Revenue prospects also hinged on the long term outlook for North Sea oil. Anybody who has been in the Treasury for any time is used to North Sea production disappointing on the downside. It was a consistent problem in the last decade. Every year the Business department or latterly DECC would project output; every year the Treasury would be disappointed. The time when North Sea revenues accounted for 8 per cent of GDP is a distant memory. The independent OBR forecasts them to fall below 1 per cent of GDP from 2035-36.

The OBR was attacked in some quarters for somehow being biased and pessimistic about North Sea oil prospects. Knowing Robert Chote as I do, I found this charge absurd.

Since the referendum we have witnessed a real life oil shock. The oil price has fallen precipitously from around $110 a barrel last June to under $50 today. This will have an impact on the regional oil industry which the Treasury is very sensitive to. But the macro-consequences within a formal currency union between two independent countries would have been much greater.

If the oil price were to remain at such levels, Treasury simulations suggests a newly independent Scotland's fiscal deficit would have been some 6 ½ per cent of GDP in 2016-17. Comparing this to the most recent forecasts from the IMF, Scotland would have become an independent country, seeking to borrow from the markets, with the largest deficit of any advanced economy.

In the same year the UK is projected to have a deficit of a little over 2 per cent of GDP. Scotland's deficit would have been over three times higher, a difference equivalent to £1370 per head.

This reveals an even stronger argument against a currency union now than before the referendum. The misalignment of Scotland and the rest of the UK's fiscal positions within a single monetary policy would have created similar problems of economic adjustment that the euro area continues to wrestle with. The Treasury's simulations suggest that the wider effects on Scotland's independent economy would be large: the unemployment rate would peak around 1 percentage point higher than if Scotland remained part of the UK. This is equivalent to around 28,000 Scottish jobs.

On the spending side, there was one dominant trend driven by demography. In the long term, the numbers of pensioners is projected to be higher in Scotland relative to the UK, putting upward pressure on public expenditure. And although it was conceivable that an independent Scotland might cut back spending in other areas, for example defence, it was difficult to see how any savings could offset upward pressure on social security spending.

It is little wonder then that the Treasury projected a widening public finance problem. And this was supported by independent commentators, such as the IFS[11].

It was perhaps inevitable that no serious bid was made during the Smith process for Scotland to take on responsibility for North Sea revenues or to change the social union whereby national insurance and pensions are reserved to the UK. There are clear benefits from risk pooling.

Currency

But it was the currency issue which ended up having the greatest resonance. The Treasury was clear from the beginning that an independent Scotland had four options: a formal currency union with the rest of the UK; sterlingisation – effectively forming a currency board as Ireland did in the 1920s; joining the Euro or floating the Scottish pound. Only one of these options – a sterling currency union - would require the UK's agreement. And so doing the analysis to inform the UK government's reaction function was absolutely critical.

Our initial paper published in April 2013 concluded that: *"the economic rationale for the continuing UK to agree to enter a formal sterling union with another state is not clear."*

Ten months later, following further analysis, the Treasury position was more definitive "*On the basis of the scale of the challenges, and the Scottish Government's proposals for addressing them, HM Treasury would advise the UK Government against entering into a currency union. There is no evidence that adequate proposals or policy changes to enable the formation of a durable currency union could be devised, agreed and implemented by both governments".*

Why did the Treasury's position harden? Partly because the more intensively the Treasury examined a currency union, the more difficulties it raised: the Euro crisis has been a salutary lesson about the potential consequences of an ill thought out currency union. Partly because of Mark Carney's influential speech in Edinburgh in January. And partly because the Scottish Government in its White Paper did not answer the questions our earlier work had posed. There was no evidence that the advocates of independence were up for the loss of sovereignty over fiscal and financial policy a currency union requires.

Ireland's experience has demonstrated that currency unions require extraordinary commitment, and a genuine desire to see closer union between the peoples involved. As the Treasury paper pointed out, the great thing about the sterling union between Scotland, Wales, Northern Ireland and England is that it has all the necessary ingredients: political union, economic integration and consent. The Scottish Government's proposals did not. More generally, the problems with the currency union proposed was that:

- the Scottish Government was still leaving the option open of moving to a different currency option in the longer term;
- the size of Scotland's banking sector created a very real risk that the rest of the UK would end up bearing most of the liquidity and solvency risk;

- the misalignment of fiscal policy in Scotland and the rest of the UK, to which I have already referred; and
- the problem of asymmetry, whereby the continuing UK could bail out Scotland but it was implausible that Scotland could bail out an economy ten times its size.

This is why I advised the Chancellor and Chief Secretary against entering into a currency union with an independent Scotland. I published that advice because I regarded it as my duty. The British state's position was being impugned. Demonstrating that the political and official state were completely aligned would further strengthen the credibility of the Government's position. And it was important that the arguments were exposed before the Referendum rather than after it.

At the time, it was argued that the Treasury was bluffing and, if Scotland voted for independence, it would change its tune since the remaining UK would have an interest in a successful Scotland. Of course, the Treasury would have had an interest in a successful Scottish economy. We would have worked closely with any new Scottish Finance Ministry just as the Treasury worked very closely with the Irish Finance Ministry in the 1920s[12]. But having discussed the issue of a formal currency union with the Chancellor, Chief Secretary and Shadow Chancellor in early 2014 I am absolutely certain that the UK would not have entered into a formal currency union with Scotland had the latter voted for independence.

Of course, there were alternatives to a formal currency union, and, amongst others, Angus Armstrong at the National Institute did a great job in analysing them.

But the principal opponents of the Union never stated their preference.

In the event, the Union survived.

And the debate rapidly moved on to further devolution.

Smith Commission

The Smith Commission's proposals maintain the Union's key ingredients: a single currency, a single market, a single fiscal policy and a social union based round the basic state pension.

Their main impact is on Scotland's tax regime – with income tax rates and thresholds fully devolved – and on funding.

The Scottish Parliament is already responsible for nearly 60% of all spending in Scotland. The further tax devolution agreed by the Smith Commission means that it will retain around 40% of Scottish tax. This will make the Scottish Parliament one of the most powerful sub-central legislatures in the OECD, behind only the Canadian Provinces and the Swiss Cantons.

While the Scottish Government already has complete flexibility over how to use its budget, it will benefit from a step change in its ability to determine the size of its budget. This can only be good for accountability.

The principles agreed by the Smith Commission are clear that there needs to be an updated fiscal framework for Scotland.

A new funding model lies at the heart of this, ensuring that spending in Scotland and the rest of the UK will be unaffected by the decision to transfer tax and spending power. The Scottish government block grant will be increased to reflect devolution of spending powers; and it will be decreased to reflect the devolution or assignment of tax receipts. As a result more than 50% of the Scottish Government's budget will be directly financed by Scottish taxpayers.

A new model will also need to incorporate the automatic interaction between UK Government tax decisions and the Barnett Formula.

If the UK government chooses to increase income tax to fund an increase in health spending, the Barnett Formula means that the Scottish Government will automatically receive a population share of the increased funding. But once income tax rates are devolved, Scottish taxpayers won't face the tax increase and so shouldn't benefit from the extra spending.

Conversely if the UK government chooses to cut spending on health or local government to fund an income tax cut, the Barnett Formula means that the Scottish Government's budget would automatically be reduced. Again once income tax rates are devolved, Scottish taxpayers won't benefit from the tax cut so shouldn't face the spending cut.

The Barnett formula will live on – outlasting its founder - but its contribution to spending by the Scottish Government will be reduced by some two thirds.

All five political parties in the Smith Commission have agreed that there needs to be a new funding model. They have agreed the outcomes that it needs to deliver. The Treasury is already working with the Scottish Government to make this happen. And of course the new regime needs to operate within the UK Government's wider fiscal policy. The UK Government will retain responsibility for UK-wide risks and economic shocks, and so Scotland will still benefit from pooling UK-wide taxes and from UK Government borrowing.

Conclusion

Her Majesty's Treasury is by its nature a unionist institution. The clue lies in its name. It serves the whole of the United Kingdom, based around offices in London, Norwich and Edinburgh. And so I think it can look back with some satisfaction with the events of the last year. Not only has the Union been preserved. But the principles which will inform its funding are moving closer into line with other decentralised or federated countries. That the Scottish Parliament will – in future - be raising tax to finance much of its spending can only be good for accountability. It should create a common interest in a well-designed tax system, and I would hope the UK and Scottish governments will learn from each other when it comes to public finance best practice. And providing the Treasury and the Scottish Government can agree a funding model consistent with the Smith principles, I am confident that we will see a public finance regime for the nations of the United Kingdom which is more stable and more durable.

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[1] *Great Britain: Identities and the Idea of Britishness* (1998), Keith Robbins

[2] Of course, bribery and the Scottish aristocracy's desire to benefit from the English aristocracy's exemption from civil actions for debt played their part too.

[3] *Treasury Control and Public Expenditure in Scotland 1885-1979*, Edited by Ian Levitt

[4] As Neil Davidson argues in *The origins of Scottish Nationhood (2000): "*Ireland was not part of the British nation, the Union merely masked the existing colonial relationship; the Highlands of Scotland were part of the nation, and the treatment it received in this period of crisis reflected this fact".

[5] Had the allocation been based on a population share, the formula would have been 76:11:13

[6] *Scotland's Public Finances from Goschen to Barnett*, Quarterly Economic Commentary, the Fraser of Allandar Institute (1999), Gavin McCrone

[7] Scotland's different geography had been recognised as early as the the 1884 road grant, where according to Levitt "the Scottish allocation of 14 per cent of the UK total recognised 'the greater mileage of main roads per head of population'".

[8] *A New Scotland: The Economy*, George Peden, from *The Oxford Handbook of Modern Scottish History (2012)*, edited by T M Devine and Jenny Wormald

[9] House of Lords, Select Committee on the Barnett Report, 1st Report of Session 2008-09: HL Paper 139.

[10] The Calman Commission of 2009 proposed the extension of income tax devolution and the devolution of landfill tax and stamp duty land tax. Its proposals were enacted in the Scotland Act (2012). Last year the Scottish Government set out its own proposals for a Land and Buildings Transactions tax to replace SDLT.

[11] The IFS concluded that "in the medium term, an independent Scotland's public finances would be in a substantially weaker position than those of the UK, unless it were to undertake further spending cuts or tax rises on top of those already pencilled in for the coming years."

[12] Brian Lenihan, the late Irish Finance Minister, once told me that the Treasury had been very supportive in the 1920s and 1930s, in particular in helping end the trade war. But cooperation did not extend to tipping the Irish off about the devaluation of sterling in 1949.