



Business, Innovation and Skills Committee

Oral evidence: The implications of Scottish Independence on business; higher education and research; and postal services, HC 378

Wednesday 5 February 2014

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Members present: Mr Adrian Bailey (Chair); Mr William Bain; Mr Paul Blomfield; Katy Clark; Mike Crockart; Caroline Dinéage; Rebecca Harris; Ann McKechin; Mr Robin Walker; Nadhim Zahawi

Questions 151 - 192

Witnesses: **Rt Hon Vince Cable MP**, Secretary of State for Business, Innovation and Skills, and **Rt Hon David Willetts MP**, Minister of State for Universities and Science, [Department for Business, Innovation and Skills] gave evidence.

Q152 Chair: Good morning, Ministers. Thank you for agreeing to speak to the Committee today—an agreement that we could not get from John Swinney. Of course we know full well who you are, but for voice transcription purposes if you would just introduce yourselves, that would be helpful.

Vince Cable: Vince Cable, Secretary of State, Business Innovation and Skills.

Mr Willetts: David Willetts, Minister for Universities and Science.

Q153 Chair: Thanks very much. I am going to open with a fairly general question. As you will be aware, in June we took evidence in Scotland, where we interviewed various business representatives. They highlighted uncertainty and lack of detail as a key risk that they were concerned with, and most reserved judgment until the publication of the Scottish independence White Paper. There are two interpretations: one, that they genuinely did not know; or two, that they were unwilling to raise their heads above the parapet. Do you think that the White Paper, now it has been published, gives them the clarity to take a position?

Vince Cable: The simple answer is no. Like you, I meet Scottish business frequently. I have been there twice in the last few weeks, and will be going frequently again. The main issue that they raise is one of uncertainty. This is a very big and weighty document that goes into a lot of detail, but it does not address the fundamental doubts that a lot of businesspeople have about currency union, what that means and whether it is

sustainable. We argue in the UK Government that we do not think it is a sustainable model. It has enormous implications for business if it does not work; there are the issues about admission to the European Union and the hiatus that would be created and would create a great deal of uncertainty for business.

I think from the business point of view, the big issue, which is touched on in here, but not in a very satisfactory way, is the problem of creating two new regulatory systems in what has hitherto been a unified system. We have a single market within the United Kingdom that is much more integrated than the European single market. I am not just talking abstractions; I will take one or two simple examples.

In most of the knowledge-based industries, intellectual property protection is a crucial factor—patents, copyright, trademarks. My understanding is that under a Scottish system they would want to have their own regulator with their own Scottish patent copyright system. That might be good, it might be bad, but it would mean that if you were trying to patent an invention in Scotland or copyright some intellectual property, you would want your Scottish documents. Those would no doubt be attractive in Scotland, but then you would need another one for trade within the rest of the UK, so you would be creating a duplicate system with a lot of uncertainty around it. One can multiply that example many, many times over.

Q154 Chair: There was an interesting statement today by Bob Dudley, and I think amongst the points he made is that this debate is far too important to be left to politicians alone. Do you agree with that, and would you welcome the observations of more leading industrialists?

Vince Cable: Yes, I think they should. When I go to Scotland I find that businesses are reluctant to take a very strong public position on this, and I am not criticising them for that. If you have a labour force or a management team where some people may be nationalists and others are not, you do not want to create discord in your own company, so for understandable reasons businesses keep quite quiet. They may be worried in a wider sense, but it is understandable.

When serious businesspeople do speak up, I think it is important. Bob Dudley is important because he is a major investor in the North Sea—the oil industry, which is absolutely critical for Scotland now and also in an independent country. He is very clear that an independent Scotland would be worrying for a major international oil company. They would have to duplicate a lot of their administration.

There would be major uncertainty for them in the run-up to and after independence about the oil tax regime, which is complex and absolutely critical to their investment decisions. Bob Dudley is clearly not speaking from a tribal point of view—he is an American, so there is no reason why he should be looking at this from a non-Scottish UK point of view; he is just looking at it as an international business. There are other sectors, not just the oil industry; in recent days we have had the financial services sector based in Scotland also expressing considerable worry.

Q155 Nadhim Zahawi: Secretary of State, you quite rightly mention BP and its role in the oil and gas sector in Scotland. The response from Alex Salmond has been that, “Of

course, they would say that, wouldn't they?"', because they are making such profits out of the natural resources of Scotland. Would you not agree that to make those profits in the first place they have to make substantial investments in Scotland, and therefore any risk of separation would mean that investment into the oil and gas sector may dry up in Scotland?

Vince Cable: I had not seen that comment from the Scottish Government, but I am surprised they have criticised BP and other oil companies for being profitable, because it is the profits that generate the savings to invest. It is crucially important for Scotland, and also for the whole UK, that we have a successful oil and gas industry in the North Sea. It is important not just for the exploration and production side; one of the most successful parts of the Scottish economy is the supply chain that has developed in the north-east around Aberdeen. It is a brilliant, highly innovative, highly successful industry, and that depends on the industry remaining profitable.

Q156 Chair: Would you agree that, given the strategic importance of the oil and gas industry to Scotland, and indeed an independent Scotland, that gives additional weight to the comments that Bob Dudley makes?

Vince Cable: Yes, it does. Scotland has two major industries; it is in many ways a very diverse economy, but it has two major industries, one of which is, and would be in an independent country, the oil and gas sector, and the other of which would be financial services. It is striking that within the last few days the strongest comments from Scottish business have come from those two sectors, which are crucial to Scotland, and where there is a very high level of worry about what an independent regime would look like.

Q157 Katy Clark: The White Paper argues that a high level of synergy can be achieved under the leadership of the Bank of England between an independent Scotland and England, in terms of macroeconomic policy. How easy do you think that would be to achieve, and what would you see as being the possibility of major strains on this approach, if the two economies and two countries diverged in their policies over time?

Vince Cable: They potentially would diverge, because Scotland, partly because of the oil and gas sector, could well move in a different direction economically. In terms of the monetary aspects, I would defer to the Governor of the Bank of England, who is not political and made it very clear he was not speaking as a politician, was not taking up a view on independence, but where he set out the logic of a monetary union. He made it absolutely clear that if there were to be a monetary union with an independent Scotland that would have consequences, one of which would be the need for a banker union, which would severely constrain the regulation of financial institutions in Scotland.

The other, which is probably more difficult for an independent Scottish Government, is that there would have to be a fiscal pact comparable to the Maastricht Treaty. An independent Scotland would be heavily constrained by requirements in terms of budget deficit management and debt obligations. Its independence would be severely constrained, and that has led to the judgement—it is our Government's view, but I think more widespread—that it would be extremely difficult to operate a monetary union with an independent Scotland. I recall that when Czechoslovakia faced the issue of velvet separation, as I think they called it, they were committed to a monetary union after independence and it lasted 33 days. There is a worry that this would have similar instability.

Q158 Mr Bain: Martin Wolf wrote a very interesting piece in the *FT* last week where he said that the Bank of England could not serve two masters. Is one of the difficulties that the proposal from the Scottish Government is to create a kind of supranational central bank on the model of the European Central Bank, when that would repeat the error of the eurozone, which was not having a fiscal union? Is it not strange that when the eurozone is trying to put that right, you have politicians on these islands who would wish to repeat that error right here?

Vince Cable: You make the point very well. I cannot do anything other than agree with it, and it actually is a deeper problem than that. The basic problem with the eurozone was not merely that they did not have a tight enough fiscal agreement at the outset, which of course constrains the independence of the periphery countries, but what they are now acknowledging is that they now have to be more politically integrated, which would be a strange conclusion to come from a breakaway.

Q159 Caroline Dinenage: VAT was highlighted as a particular concern of business. If the two countries had a shared approach to economic policy, could that accommodate differences in taxation—VAT, business rates, etc.?

Vince Cable: Is the issue about the value added tax regime?

Caroline Dinenage: The VAT, yes, but other taxation and business rates, that sort of thing. Could that be accommodated?

Vince Cable: Of course, an independent country would be free to set its own tax rates, but it nonetheless would have to do it within a fiscal framework, which, if the Scottish Government had its way, would be fairly tightly constrained within a currency union.

In terms of setting individual tax rates, there are several problem areas: one of them is value added tax. The UK is zero-rated, and it is one of a few countries that has achieved that derogation. If Scotland, as an independent country, reapplied to join the European Union—and I think you have all heard the arguments about the tricky legal issues there—it is quite likely that they would be expected to observe the minimum VAT rate, which is 5%. The zero rating, which operates at a UK level, probably would not be something that they could achieve.

There is a complex argument there, but I would think that is a reasonable assertion. They would start off with different VAT rates for key areas of household budgets. There are then all the practical problems of setting up different VAT administration systems in the two countries, and the practical problems of businesses that trade across the border. Of course, there is a lot of cross-border trade, and one would hope that that would continue, but if you are involved in cross-border trade there are issues like how you get your reclaim on your petrol, which currently operates through a UK tax system. As I understand it, it would have to go through a VAT pooling arrangement in Europe, which is more complicated and bureaucratic, and certainly tricky for business to have to engage with. That is simply with regard to value added tax, and there are obviously parallel issues with other taxes.

Q160 Caroline Dinenage: I know you have touched on the relationship with the Bank of England already, but I wondered if you could tell me what discussions the UK Government has had with both the Scottish Government and the Bank of England on the practicality and desirability of the Bank of England's oversight of macroeconomic policy.

Vince Cable: I am not the person to ask, because my Department does not cover monetary policy, directly or indirectly, but I can pass on a general observation as somebody in Government. If there were to be a banking union, which is what I think the Governor has said quite categorically would have to exist if there were a currency union, it would cover several things. It would cover the protection of deposits, and it would cover supervision, and, most crucially, it would cover lender of last resort—in other words, if a bank collapses then the Bank of England, as the supervisory authority, would have to take responsibility for that. There would have to be tight control exercised over Scottish-based institutions to make sure that they did not pose a threat to systemic stability.

The crucial issue here is about the Royal Bank of Scotland, which was, in balance sheet terms, the biggest bank in the world, or close to it; it still is a very big institution. On some estimates its balance sheet is 10 to 12 times the size of the Scottish economy. That, almost by definition, creates a high level of potential instability, which that currency union would have to address. There is the question then about whether RBS would choose to relocate its headquarters to London, where its management already is, to avoid those systemic risk issues. There is a lot of uncertainty about what this would mean for regulation of the banks.

If I take just one other example in the financial sector, a very simple thing like ISAs, for stocks and shares: as I understand it that is a UK product. You would have Scottish institutions that do very well in marketing their products across the UK, and it is the biggest export industry from Scotland, that would not be able to sell ISAs. They would be considerably restricted in what they could do, and there are some little practical problems of that kind that would occur within the kind of arrangements we are talking about.

Q161 Mr Bain: Given the growing list of factors that really make the idea of a currency union less attractive by the day, for people not just in a potential separate Scotland, but for England, Wales and Northern Ireland too, do you think it is now perhaps incumbent, Secretary of State, on the Scottish Government to set out what their plan B would be—i.e. what would be their choice for currency arrangements if a formal currency union with the UK was not available? What would the implications of that be for RBS, for example?

Vince Cable: The plan B is a fully separate currency, and the logic of what the Governor and other people have spelled out is that the problems of a currency union with an independent Scotland are so difficult, so tricky, that it would almost certainly prove to be in Scotland's interests, and, indeed the rest of the UK, that Scotland did have its own currency, although, of course, that would create a whole wave of other problems. It would create a barrier to trade across the Scottish border, as different currencies tend to do, and there would be the problems of managing a fluctuating exchange rate of a country that is very dependent on raw materials. The basic arguments about the problems of operating a monetary union suggest that Scotland would finish up with its own currency, with all the advantages and disadvantages that attach to it.

Q162 Mr Bain: If the Bank of England were not available, therefore, as lender of last resort, what implication would that have for the future of RBS, in your view?

Vince Cable: If you were managing RBS, you would almost certainly want to be in a domicile where your bank is protected against the risk of collapse. They already have a substantial amount of their management in London, and I would have thought that inevitably they would become a London bank. That would be symbolically quite important, because I think they were established in 1707 as a Scottish institution; I think that might well sever it.

Q163 Chair: Just before I move on to Mike Crockart on EU membership, just really a curiosity: you earlier described ISAs as being a UK product. I am slightly at a loss, not being a banker, to understand how they are a UK product when they are sold by Scottish banks, I presume, and others in Scotland, and what implications that has. Could you just amplify that?

Vince Cable: I could set out the details for you in a letter, if you like. As I understand it, the legal position is that ISAs are UK products, and it would mean that a Scottish institution that sells ISAs—some of them do, and they do it very well; there are some very good Scottish financial institutions—would be selling into a foreign country. It is not clear that the regulatory arrangements covering ISAs would then apply to them.

Chair: If you could send us a letter, I would be very grateful. Can I bring in Mike Crockart on the issues surrounding EU membership?

Q164 Mike Crockart: You did say earlier that we have all heard the arguments; I am afraid we are going to have to go through them again, because it is an area that keeps coming up. In the evidence sessions that we have had already it is one of the main concerns, especially of businesses in Scotland. What is your current view of the Scottish Government's argument that Scotland would retain EU status? It is the Article 48 versus Article 49 argument about retention of EU membership versus applying to join.

Vince Cable: My understanding is no better or deeper than the common view, which is based on the legal advice that has been given that Scotland would have to reapply for EU membership. That is by no means a given, particularly as some other members of the European Union also have anxieties about breakaway movements within their own countries. No doubt membership could be achieved, but the point one wants to make about it is that it just creates a new tier of uncertainty, a level of uncertainty, which has big implications, particularly for business decisions.

Q165 Mike Crockart: You were talking about legal advice; what is the legal basis for that position that the UK Government holds?

Vince Cable: As I say, I am not a constitutional lawyer, and you are as familiar as I am with the various legal opinions that have been given. I know independent legal advice has been sought, independent of our UK Government, which confirms that. Again, we can put all this in writing for you, if you like, but I think it has been extensively gone over.

Q166 Mike Crockart: One of the difficulties is that, in a previous evidence session, for example, we heard evidence from Gordon MacIntyre-Kemp, who is a member of the Business for Scotland organisation. His argument was basically that we could get this sorted out if the UK Government, as the current member of the EU, were to go to the EU and ask for a proper opinion about what the status of Scotland would be in the case of a yes vote, but the UK Government is somehow refusing to do that. Is that your understanding? Have you gone to the EU to ask for a response?

Vince Cable: It is a slightly naive view about the way the European Union works. This is not an issue solely in the possession of the British Government; it would require the assent of all the other European countries, and we know that some of them would have some anxieties about the role of an independent Scotland. Why should the British Government be doing this? We are dealing with the status quo. We are dealing with the reality. Scotland is part of the UK, we want it to stay there, and there is no reason why we should be acting on hypothetical possibilities of that kind.

Q167 Mike Crockart: The whole point of this worry, as we have already said, is about uncertainty. If, in the case of a yes vote, we then entered into 18 months of protracted negotiations, as is foreseen, what would the implications of that protracted period of uncertainty be for UK businesses and Scottish businesses in particular?

Vince Cable: The British Government is not creating the uncertainty. We have a good, stable structure, which works very well for Scotland and the rest of the UK, and we want to keep it that way. One simply cannot predict, as in several other major areas of policy, what the consequences of that hiatus would be. Our understanding is that both legally and in terms of the politics of the European Union it would be quite difficult to migrate Scotland to independent membership. It may well prove to be trouble-free; we do not know. There is simply a big uncertainty around that whole process. It could take a long time, it could take a short time, but it is the uncertainty around it that is the problem. It would be damaging for the whole of the UK if that situation arose, and it would be especially damaging for Scotland.

Q168 Ann McKechnie: Just a very quick point, Secretary of State, the Scottish Government has unilaterally proposed an 18-month period of negotiation with the European Union, to ensure that membership is sustained if there was a separation. Are you aware of any discussions that the Scottish Government has had with the remaining 27 members of the European Union as to whether or not an 18-month timetable would be acceptable to them?

Vince Cable: I am not aware of any, but you are asking the right question. Their consent is required, and the Scottish Government could not take that for granted.

Q169 Mr Bain: Following on from Ann McKechnie's point, I received a written Parliamentary answer from the Minister for Europe, which indicated that the period of negotiation on the terms of re-accession could not begin until the date of Scottish statehood, which the Scottish Government anticipate would be in March 2016. If that is simply the starting point for the negotiations, does that not mean that Scotland would face being excluded from the EU single market for the period of those negotiations, and what impact would that have on manufacturing exporters in Scotland if that were the case?

Vince Cable: You describe a worst-case scenario. It is quite possible that the status quo would be maintained in the interim—I do not know—but if you are a business investor worried about risk and uncertainty then that is exactly the kind of question that you would be worrying about.

Q170 Rebecca Harris: Just going back to the questions of euro or sterling, it seems the Scottish Government's preferred option is a sterling zone, which retains the pound. In your view, would that be the most beneficial option for Scottish businesses in terms of their trade with the remainder of the EU?

Vince Cable: The best option by far for Scottish business is that they remain within the UK. A very substantial part of their business is accounted for by trade with the rest of the UK; something of the order of 30% of Scottish GDP is accounted for by trade with the rest of the UK. Clearly you would want an arrangement that maintains that. In terms of the other options we have discussed two already, one of which is the currency union, which is difficult to sustain, or the option of a separate currency. They could join the euro; that would be another possibility, but the problem there is that trade with the rest of the UK is four times bigger than trade with the eurozone, so there would be quite a severe dislocation around the currency movements that would follow that.

Q171 Rebecca Harris: For the purposes of Scottish business viewing this as a future option, what do you think are the main practical obstacles that there might be for having such a currency zone?

Vince Cable: First of all, there is negotiating the arrangements; secondly, there are the business costs of fluctuating currencies. If they join the euro, which I think is the hypothesis you are putting forward, there is the effect that that would have on euro-sterling trade across the border. There is also the whole doubt about the problem within the eurozone as it currently is, and the fact that they are now moving to a much closer banking union and fiscal disciplines, which currently do not prevail and Scotland is not currently part of that discussion.

Q172 Rebecca Harris: In our previous evidence sessions, one of our witnesses suggested that the key obstacle of having a sterling zone with Scotland was actually political disagreement between the UK and Scotland. Do you think that is a fair assessment?

Vince Cable: Yes, and I think this goes over the ground we have had before: that in order to have a currency union with an independent Scotland, we would need to agree to have a banking union that has major implications, some of which we touched on. The most difficult of all would be the agreement on a fiscal compact and fiscal disciplines, because that touches straight on issues of national sovereignty. Scotland would have to accept obligations in respect of its deficit financing and in respect of debt, both of which would be highly contentious, and would probably be very difficult for managing the Scottish budget.

Q173 Mr Bain: We have heard already some of the issues and difficulties about a currency zone. To what extent would you say that, with an independent Scotland in a sterling

currency zone, if it were achievable, the arrangements would differ in terms of relationships from the current devolution arrangements?

Vince Cable: Again, I am repeating myself, but the key requirements—and I think Mr Carney spelt this out very clearly—is, of course, you need to have two highly integrated economies. We do have that. It would need to have a banking union, because of the instability, and the fact that Scotland is currently host to major global banks, and the problems they present for financial stability. The key is you have to have a fiscal agreement. Maybe just to go with the reasons for that, the danger of having a currency union with a country where you do not have a fiscal compact is that Scotland, in this case, would seek to run large deficits and borrow against the UK Government's creditworthiness. Clearly, as the other side of it, the rest of the UK would want to make sure that did not happen, so they would want to, and would have to, bind in an independent Scottish Government to some very tough fiscal disciplines.

All we know about the Scottish budget situation several years hence, and there is some discussion of it in here—there is one table and a couple of scenarios—is that it would be quite difficult to manage, because their receipts depend very largely on oil revenue, which is a depleting resource and increasingly high cost. In a world where we cannot predict the future price of oil, they would have to bind themselves in to very tough fiscal disciplines, in an environment where they have got only indirect control over their main source of revenue. It is very difficult to see how this could avoid quite severe cuts in public spending, but clearly that would depend on the assumptions you make on revenue.

Q174 Mr Bain: Indeed, and that has been the position of the IFS, who have said that moving towards a separate Scotland, whether it is under a currency union or any other currency regime, would mean that taxes would have to go up or spending would have to fall. I think the IFS are seen as a widely respected authority. If we can explore this issue a little further, is it not the case that the Government has found that whatever the currency system a separate Scotland would adopt, borrowing costs would go up? Obviously, that would have an implication on the lending that might occur from the banks in Scotland to businesses that were in Scotland, would it not?

Vince Cable: Borrowing costs through the bond market—we know in the UK we have got quite competitive rates that have been achieved in a rather painful way, but we do, and if you are an independent country starting to borrow, first of all the markets do not know who you are, and there is an uncertainty around that. The fact that there might be, and the Scottish Government have promised this, a serious argument about debt obligations and how much an independent Scotland would be willing to carry, could cast doubt amongst any creditors about whether this a serious borrower who could be trusted, and that would be reflected in the spread over the rest of the UK's borrowing rates. Other things being equal, you would expect borrowing rates to be higher than in the rest of the UK, and depending on how difficult the negotiation process was, they could be very substantially higher.

Q175 Mr Bain: Again, if a sterling currency union is not achievable, and some other system were adopted, whether it is a separate Scottish currency or sterlingisation, the implications for business lending are quite severe. If you look at some of the IMF literature on countries that have dollar-ised or euro-ised, we can see that the amount of capital the

banks have got to hold is greater. Therefore that would mean that there would be less money available for banks to lend to businesses, would it not?

Vince Cable: Yes—you are ahead of me on the IMF reading, but certainly from my recollection of economics generally, the point you put is right. There are a few examples of dollarisation—I think Argentina did briefly for some time, and it was a disastrous experiment, and it has been even more disastrous since. There are one or two examples of attempts to peg against another currency. Some have been successful: Hong Kong is a successful example of dollarisation, but they have very, very severe rules on capital liquidity to reflect that dependence. It certainly constrains what an independent country can do.

Q176 Mr Bain: You spoke earlier about the issue about the integrated labour markets and the integrated product markets that we have across the UK. It is very interesting, when you look at the Government's analysis paper on macroeconomic and fiscal performance, to look at some countries that have disaggregated and the effect on trade. If you look at, for example, page 60 of that analysis paper, when Czechoslovakia dissolved, the level of trade between each part of that constituent country diminished rapidly in the decade after the dissolution of that country. That is because there were barriers put up to trade, were there not? Is that not likely to be the same scenario if Scotland separated from the rest of the UK?

Vince Cable: Yes, but even if one puts it in quite a constructive way, and we do not create alarming stories of trade warfare—they are improbable, but there is a risk—and just assume that we moved into a single market operating between two independent countries, there is a useful comparator, which is with Canada. Canada, like the UK now, is a very devolved system, very federal, but the trade between Canadian states is something of the order of 20 times as intense as with the United States. Their relations with the United States are quite amicable, and they have the NAFTA agreement, and so on. Those hidden barriers are very substantial and do act as a barrier to trade, even with countries that are friendly and have trade agreements.

Q177 Ann McKechin: The Scottish Government's White Paper states they would create a Scottish regulator who would assume the key responsibilities of the Financial Conduct Authority. Given the importance of the financial services market to the Scottish economy, which you have mentioned in your earlier remarks this morning, and the services which they in turn provide to England—in fact, in many cases the bulk of their customers are in the rest of the UK—what is your assessment of the impact of companies working under two separate regulators?

Vince Cable: Of course, it does two things. It raises costs; somebody has got to pay for that regulator, and regulators are normally financed by levies on their industry—certainly that is true in the UK—and it does create uncertainty about what that regulatory regime might be. As you know, because you have interrogated people at the UK level, the rules are often very complex. There are two problems, and that is why some of the leading fund managers in Scotland have spoken up with some alarm and, of course, they depend on the UK market. I think 85% of the sales of Scottish enterprises—their exports, financial services sector—are in the UK market, and not just domestically in Scotland.

Q178 Ann McKechin: You made a very interesting comment earlier this morning about the issue of the treatment of ISAs, and obviously this is a very important product in the financial services market. For many companies in Scotland, as I have said, most of their customers are based in the rest of the UK. If they became a foreign registered company, with selling these products, and vice versa where Scots held ISAs in companies that are registered in other parts of the United Kingdom, clearly there would be an impact if the tax treatment of these particular products changed.

Vince Cable: Yes. As I said earlier, ISAs are designed, I think the regulations specify, for UK customers living in the UK.

Ann McKechin: Domestic use, yes.

Vince Cable: The existing tax arrangement would fall, and Scotland might wish to reintroduce them, but that would be their concern.

Q179 Ann McKechin: Yes, but that would be tax treatment for their own taxpayers in Scotland, but it would not be the same for taxpayers who are in the rest of the UK?

Vince Cable: That is correct.

Q180 Ann McKechin: Thank you for that clarification. The White Paper also argues that the Scottish regulator would be closely harmonised with the UK regulators and retain a broadly integrated market across the sterling area. Of course, this is in the presumption that there would be a shared sterling area, and we have obviously talked about that. In the longer term, do you see that there could be inherent friction as the economy started to diverge? Clearly the intention is at some point the economies would start to diverge.

Vince Cable: Yes. The divergence could happen in a variety of ways. If, as we feel is likely, Scotland did acquire its own currency, because that is what independence would really lead to, that clearly affects the rate of exchange. Potentially with an oil-based economy on one hand, and a more broadly-based UK on the other, those divergences in exchange rates can be very considerable, and affect business costs on both sides of the border. The divergence would take a more extreme form if you had different exchange rates, but we have argued that that would be almost certainly an inevitable consequence of independence, because the currency union is not really sustainable.

Q181 Ann McKechin: Another important point for investors, as well as the tax status of the products they purchase, is the compensation scheme, and obviously investors here in the UK benefit from the current financial compensation scheme. The White Paper proposes that there would be some merit in a jointly operated or coordinated scheme across the sterling area for key aspects of compensation. Do you think that that is either practical or desirable?

Vince Cable: To have a proper banking union, you would have to have agreement on compensation, presumably for depositors, were a bank to fail. That is inherent in what the banking union means. How practical it was would depend probably on the future of RBS, which so swamps the rest of the banking system in Scotland. If it were relocated to London, then the issues would be less onerous, but if it remained within Scotland, clearly the one big epic event would be a collapse of that bank and the obligations that would

follow in terms of depositor compensation—a highly improbably event maybe, in view of what has happened to shore it up, but that would be the big issue that the regulators would have to focus on.

Q182 Ann McKechin: Presumably if such a scheme did take place the level of funding and the levy on business would obviously, as you say, be quite different if RBS was headquartered in Scotland or, alternatively, if it was headquartered in another part of the UK. Would it be a 50-50 basis between Governments, or would it be proportionate to the size of the country, or the economy, or the population, or the size of the financial services sector?

Vince Cable: We are not in negotiating territory. As a matter of principle, we are not setting out definitively how those things would operate, but the mere fact that you asked the question with five potential answers raises the issue, which is that there would be a high level of uncertainty.

Chair: Minister Willetts, you have been waiting there patiently; this is your moment in the spotlight. Can I bring in Paul Blomfield on higher education?

Q183 Paul Blomfield: Let us start with the issue of fees charging. The Scottish Government's White Paper, as you know, says that they will maintain their current policy of charging fees for Scottish institutions to students from the rest of the UK. Is that legal in your view?

Mr Willetts: The view seems pretty clear that if Scotland were to be a separate state within the EU it would not be legal, because there is a very clear legal framework within the EU that you cannot discriminate against members of other member states. I quote the spokesman for the European Commissioner for Education, who said that, "Unequal treatment based on nationality [...] is regarded as discrimination, which is prohibited by Article 18 of the Treaty on the Functioning of the EU".

Q184 Paul Blomfield: There has been some suggestion, in a way that looks a bit like grasping at straws, that there is a possibility that Scotland could, in discussion with the European Union, seek what is described as an objective justification for maintaining this policy. You will probably be aware that that has been tried by other EU member states—I think Austria and Belgium—and failed. Can you see any reason why it would succeed for Scotland?

Mr Willetts: No, we cannot see any reason why it would succeed in Scotland, and that is not just the view of us or the European Commission; in my understanding, it is the view of the vast majority of legal experts. The professor of European Union law at Edinburgh saying that the Scottish Government would face "an extremely steep uphill battle" to convince the EU that they could carry on charging students from the continuing UK.

Paul Blomfield: And it would be unprecedented in the UK.

Mr Willetts: It would indeed be unprecedented. It does appear to be contrary to EU law. As well as all the legal issues, the other point is that, if you imagine that this scenario were to occur and the Scottish Government were trying to do this, they would have just secured independence, we have been talking about all these negotiations going

on, we are told that they would like continuing friendly relations with the rest of the UK, and then one of their first acts would be to try to do something that specifically discriminated against English students going to Scottish universities, and gave them different treatment than French and German students going to Scottish universities, despite the fact we are all member states, on their intentions, of the EU. It would be a very odd way to try to conduct yourself, and it would be a bad start for your relations with a fellow EU state.

Q185 Paul Blomfield: Perhaps I can move on to look at another example, or another area of higher education funding, where the Scottish Government would be, just following on from your last point, looking for very positive engagement with the rest of the UK, and that is on research funding.

The Scottish Government's White Paper says they want to retain a common research area of funding through the UK research councils. They also go on to say on this specific issue something along the lines of a fair funding formula based on population. You will know that currently Scottish universities disproportionately benefit: I think they get about 13% of UK Research Council funding, and only have about 8.4% of the UK population. Do you think that is sustainable going forward?

Mr Willetts: No, again, we do not think that is sustainable. We have, of course, set out in our "Science and Research" paper for Scotland absolutely the figures that do show that, at the moment, it is an integrated UK system and the allocation of funding is by excellence. There are excellent research institutions in Scotland, and so it does better than its percentage of GDP, as you say—13% against 8%.

If Scotland were to separate, of course one would hope for continuing research collaboration, but it would be between two separate countries. The basis on which we do research collaboration with France or Germany or the US, in general, is we pick up the costs incurred in our country, and the French or the Germans pick up the costs incurred in their countries. You have to come to some kind of overarching project, but that is how you allocate costs. That would be how it would have to work in this case. The rest of the UK would not be using the rest of the UK's research budget to pay for institutions in Scotland.

Q186 Paul Blomfield: That is pretty clear. Could I move to an issue that we have discussed a lot recently: the student loan? If Scotland votes yes for independence, what would happen to student loans attached to Scottish universities? Would they remain a UK liability, or would a proportion be transferred to the Scottish Government?

Mr Willetts: Let me report on the current arrangements, because with all these things future arrangements would have to be negotiated. At the moment, we already have a very clear sense, in the Student Loans Company, of English loans and Scottish loans. I consult and inform my opposite numbers in the other Administrations when we are thinking, in England, of doing something for English loans. For example, for the sale of the mortgage-style loan book, when I consulted other parts of the UK who also had some of these unpaid mortgage-style loans, we agree on a UK-wide sale, and Scotland got some of the proceeds; we estimate it was about £22 million out of £160 million.

For the pre-Brown income contingent loans, which indeed we talked about recently, at present the sale of the initial tranche of the income contingent loan is focused solely on the English loans, and we have a distinct identity; there are separate Scottish loans, and Scottish Ministers have decided not to participate in the loan sale. They have already a separate lien on loans issued by Scottish institutions, and if they do not want to sell them under the devolved settlement, they do not have to sell them, and that is not their plan.

Q187 Mr Walker: The Scottish Government has given an undertaking to renationalise its share of Royal Mail if it were to win the referendum. Have you made an evaluation of the percentage of Royal Mail that would be Scottish in that respect?

Vince Cable: No, we have not. We do not expect or want this to happen. Of course, it would depend on the value of the company, a subject I know your Committee have a great deal of interest in, but, no, we have not committed to that exercise.

Q188 Mr Walker: They have talked about the need for negotiations with the UK Government to establish what Scotland's share of the UK Government's remaining stake would be, but presumably there would also be a need for negotiation with shareholders and substantial compensation, if they were to go ahead with any such move?

Vince Cable: Yes. There are two sets of problems: one is the one you describe, which is nationalising one part of it, and all the problems of identifying the respective share; the other is identifying the Scottish universal service obligation, and who would then pay for it. Overall, it is about the cost of the delivery system through the universal services—about £7 billion. The Scottish share of that is roughly £630 million, plus any additional costs that come from higher deliveries in the Highlands and so on. There would be an issue about how they would pay for the universal service obligation, which is the public duty of the Royal Mail.

Q189 Mr Walker: Just on the universal service obligation, I notice that the White Paper makes a number of statements about what they would try to achieve, including a greater priority given to improving geographical coverage. Given that Scotland already contains some of the most remote and rural areas in the UK, how sustainable would that make a Scottish Royal Mail if it was trying to improve its service to that and run it? What would be the cost of doing it?

Vince Cable: It would be significantly costly. We have tried to establish with the Royal Mail what the extra unit cost of the USO is in Scotland. We have not got a figure from them, and they argue it is just too complicated, and I am sure it is. Clearly, yes, there would be a considerable extra cost. There is one other issue, which I noticed recently—I had not previously spotted—that there is a serious imbalance in the trade in mail between Scotland and the rest of the UK. Scotland imports three times as much mail as it exports; people send them more letters and parcels than come back. That, of course, has to be distributed, so there is the extra cost of the distribution of the incoming mail.

Q190 Mr Walker: Would that be likely to result in a different stamp price in Scotland if you had two different systems and that type of imbalance?

Vince Cable: Either that or a bigger subsidy, which raises the question about how you finance the subsidy.

Q191 Mr Walker: Just a final question: obviously one of the reasons why successive Governments of different political parties have tried to bring private capital into Royal Mail is to finance new equipment and new change to make the service more sustainable. Without that private capital, what sort of scale of investment would Royal Mail need from the Treasury, whether it be UK or Scottish, to deliver change in the public sector?

Vince Cable: It would add to their borrowing costs, and we had the discussion earlier about the costs of a newly independent country trying to borrow externally and, of course, that would add to it, or else the investment would not happen and you would get a deteriorating service over time.

Q192 Chair: Just picking up on Robin's questions, Consumer Futures has stated that in the event of Scottish independence, and I quote, "the entire regulatory, governance, policy, and contractual framework for postal services and the Post Office network would need to be revisited". Have you made any estimate of the costs to Scotland of replicating those separately in Scotland?

Vince Cable: We have tried to be more precise than the estimates I have just given you, and we have not obtained detailed information. There are the Royal Mail USO issues, which we have just discussed, but there is also the issue about sustaining the Post Office network, which, as you know, we have heavily subsidised and tried to modernise. That is a continuing obligation that we have tried to keep going in this Government, despite the pressures on public finance, and an independent Scotland would have to find a way of financing that itself, particularly given that quite a high percentage of the remote post offices that are not commercially viable would be in Scotland.

Q193 Chair: Would post from an independent Scotland be classified as overseas mail?

Vince Cable: It would have to be, actually. There is a question of inward and outward. If one was sending mail into Scotland, it would be sent on the basis that this is a European country, assuming they have overcome all the problems of European membership. Assuming those are overcome, it would take place in the same way that we would send letters to France and Germany. They would obviously have to make a decision themselves as to the basis on which they send mail from Scotland to the rest of the UK. Ireland has an "all Ireland" rate, and it would be up to them whether they wish to copy that arrangement.

If I can just explain a little bit, Northern Ireland operates on the basis that Southern Ireland is part of Europe, whereas Ireland, in its postal system, acts on the assumption that Northern Ireland is part of Ireland. It is a perfectly amicable arrangement, but the question is whether you would want to duplicate a version of that in the UK, but that would be for the Scottish Government to decide.

Chair: That would be ironic.

Vince Cable: It would be ironic.

Chair: On that note, Minister, I have no further questions. Does any member of the team? No. In that case, Ministers, can I thank you very much for your observations? Obviously we will do a report in due course, and we would welcome the Government's comments on it. Thank you very much; that was very helpful.

