

## **ECONOMIC POLICY OPTIONS FOR A SCOTTISH PARLIAMENT**

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### **INTRODUCTION**

This article considers the impact on the Scottish economy of alternative constitutional arrangements. A reappraisal is appropriate because of the continuing interest in constitutional change in Scotland and the dearth of informed debate on its economic impact. In the paper, we discuss the impact of both devolution and independence, but assume that whatever constitutional change takes place, Scotland remains within the European Community.

The post-war debate on the economic impact of constitutional change in Scotland has undergone a series of cycles in popularity. Different aspects of the debate have been highlighted at different times. In the 1970s, the issue of North Sea Oil was very much to the fore. The impact of oil on the UK balance of payments and government finances was becoming obvious and individuals such as D Mackay and C Smallwood conducted debates through the press on its economic impact on an independent Scotland. Smallwood argued that the favourable balance of payments would lead to currency appreciation and loss of competitiveness in the manufacturing sector, while Mackay responded that capital outflows could be used to offset any such appreciation. These and other debates are discussed in Mackay and Mackay (1975), Mackay (1979) and Mackay (1980). The declining importance of North Sea Oil revenues has moderated interest in this aspect of the debate, but by the 1990s, as we shall see, new issues, such as the relationship between Scotland and Europe, had arisen.

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When considering the economic aspects of constitutional change, it is important to take account of broader questions about the political rationale for change, and its implications for the role of the state in Scotland. A first rationale for constitutional change is based on views as to the best scale of government for administrative purposes: European integration can be argued to justify smaller national administrative units, according to the principle of subsidiarity. These arguments refer to scale, not to regional distinctiveness.

A second rationale for constitutional change for Scotland stems from a sense that there is a cohesion within Scotland, in terms of values and institutions, which is not democratically reflected in a system of government at the UK level. This view has implications not only for the content of government policy as it affects Scotland, but also for the role that the state takes in Scotland. It can be argued that the values held in common in Scotland reflect a sense of moral and social cohesion, reinforced by national institutions, which cuts across class interests. Thomas Chalmers developed a distinctively Scottish view of the state in the nineteenth century, reflecting this moral and social cohesion. He placed great importance on the scope for community action. In modern terms his ideas would translate into the state acting as partner to community action, in a spirit of co-operation; this contrasts with the authoritative, centralised role of the state to which we have become accustomed. The current evidence of co-operative behaviour in the financial sector in Scotland, and between Scottish Enterprise and the financial sector, for example, suggests that Chalmers' ideas do still reflect a particularly Scottish ethos. Thus, in considering the possibilities for economic policy under constitutional change, care must be taken to allow for different types of economic policy, especially those which evolve as part of a co-operative ethos; this is particularly important in the context of European integration which reduces the scope for independent economic policy-making by national governments, far less by regional governments.

Since effective policy decisions are to be made increasingly at the EU level, a third, strategic argument can be made for constitutional change. To the extent that Scottish interests are not otherwise represented at the European level by the UK government, there is a case for constitutional change which would allow Scotland direct representation at the EC level.

Thus, there are several arguments which can be made in support of constitutional change. Some apply equally to independence and devolution. Others, such as the issue of representation at EU level are more appropriate to independence. This paper is not concerned with evaluating their respective

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merits. Instead we concentrate on developing and contrasting the economic implications of both.

We begin with a caveat. There are no crystal balls available in which one could track the economic performance of Scotland under different constitutional arrangements. From our current state of knowledge, it is impossible to predict whether constitutional change would have a beneficial or a detrimental effect on, for example, average living standards or unemployment in Scotland: the outcome would depend on the unknown responses of workers, consumers and firms to the new political environment. There are no sufficiently close parallels from which extrapolation might be plausible. Neither is prediction based on Scotland's recent economic performance likely to be of value if changes in the institutional framework result in alterations in the behaviour of economic agents, particularly those which might result from an increase in the level and scope of social cohesion. Further, the Scottish parliament might weight indicators of economic welfare differently from the UK and thus wish to see its own performance judged by different standards.

One main conclusion is that the ability of an independent Scottish government effectively to pursue a distinctive economic policy in a conventional sense would be severely curtailed in a world of increasing economic interdependence. Due to the openness of the economy, the Scottish administration would not be free to set taxes or monetary policy without paying close attention to the policy framework elsewhere in the EU and most notably in the rest of the UK.

The weakening of the nation state's control over its own economy is a global phenomenon. Political boundaries are becoming increasingly irrelevant in delineating areas of self-contained economic activity. As a result, no country is able to formulate economic policy without considering how agents outwith the economy will react. Reaction may be driven by the market or by the legal process. This latter form is particularly important in the European context where freedom to formulate economic policy unilaterally is heavily curtailed by agreements such as the Treaty of Rome, the Single European Act and the Maastricht agreement.

Nevertheless, it would be unwise to exaggerate the extent and speed of European integration. Expansion of the EU and political differences among the existing members are likely to restrain the speed of harmonisation of fiscal and monetary policy. Even if integration does proceed apace, we conclude that there would still be scope for less conventional forms of

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economic policy, notably those based on encouraging co-operation between different economic groups in the pursuit of common economic objectives, rather than fiscal or regulatory measures.

The current state of the Scottish economy is an indication of how it has fared under existing constitutional arrangements. Thus the next section briefly considers the health of the economy relative to other parts of the UK and to the rest of the EU. In the following section, we consider the context in which economic policy in Scotland might be formed following constitutional change. Then we look at fiscal policy and at how monetary policy might be framed under devolution or independence. The final section draws some brief conclusions.

### **SCOTLAND WITHIN THE UNION**

The Scottish economy has a civilian workforce of just under 2.5 million individuals who produced goods and services worth £44 billion in 1992, 8.7 per cent of the UK total. With a population of 5.1 million, per capita GDP in 1992 was £8652. Excluding oil, the value of the goods and services produced in the UK as a whole in 1992 was £508 billion, implying a per capita GDP of £8766, only 1 per cent higher than in Scotland. If the contribution to the UK GDP of North Sea Oil were mainly attributed to Scotland, Scottish GDP per head would increase to slightly less than that in the South East of England, the most prosperous region in the UK, but would be substantially higher than in other regions.

In terms of per capita GDP relative to the rest of Europe, recent figures (**Regional Trends**, 1993) place Scotland at around the EU average. This implies that Scotland's per capita GDP is the same as that in Belgium, but apparently higher than in all of Greece, Spain, Southern Italy, Portugal, Eire, parts of Holland, much of France, and the rest of the UK excepting the South-East of England, East Anglia and the South-West of England. Cost-of-living differences should be taken into account when trying to make a comparison of the real purchasing power of such incomes. Nevertheless, it would take a major adjustment to take Scotland away from the middle-ranking group of European regions.

The Scottish economy has undergone substantial structural change in recent times. In particular, employment in the manufacturing sector has declined in relative importance while services have grown substantially. Even within the manufacturing sector, the composition of output has changed, with reliance

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on the traditional heavy industries declining, and new industries, such as electronics, emerging as the main engines of growth.

However, such structural change should not be viewed in isolation. Most other developed countries have experienced a decline in manufacturing and a growth of services. Such change appears to be independent of government policy. Shera and Robertson (1991) note that the growth of the service sector in Scotland has been similar to that experienced in other OECD countries. The new dominant industries have different employment structures from the traditional industries and this is inevitably reflected in changes in the pattern of unemployment. Traditionally unemployment rates in Scotland have been higher than those in the rest of the UK. These were attributed to wider fluctuations in demand in manufacturing industries such as shipbuilding, heavy engineering, steel making etc.

Since 1990, unemployment rates in Scotland have been below those of the UK as a whole for the first time since the figures were collected in their present form. It would be wrong to attribute the relative improvement simply to the fact that dependence on traditional industries has declined. Other factors which may have contributed to Scotland's relative stability during the 1989-92 recession are the larger size of the public sector in Scotland (public administration and defence contributing 8.1% of Scottish GDP, compared with 7.1% in the UK as a whole), a lack of dynamism in the small firm sector which inhibits growth during expansion and maintains it during recessions, and Scottish households' more favourable private debt position, particularly in respect of housing.

Thus, for a variety of reasons, the Scottish economy has been less adversely affected by the most recent recession compared with most other parts of the UK. Indeed, far from being particularly prone to recession, the performance of the Scottish economy throughout the late 1970s and 1980s suggests that it is, if anything, more stable than the UK as a whole.

Part of the reason for its stability is that the Scottish economy is extremely open and hence not reliant on a narrow range of markets. The recently published input-output tables (see, for example, Alexander and Whyte (1995)), show that, in 1989, the value of Scottish exports to the rest of the UK was £12.2bn, while £10.1bn went to the rest of the world. Given that GDP in that year was £35.9bn, the extent of dependence of the Scottish economy on external markets is clear. The tables also calibrate the extent of Scotland's balance of trade deficit. Imports from the rest of the UK in 1989 were £20.7bn and those from overseas were £13.2bn.

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To summarise, the Scottish economy is not substantially poorer than other parts of the UK with the exception of the South East. In European terms, it is also a middle-income region. Following a period of substantial structural change, it appears to be more stable compared to the rest of the UK at least in terms of fluctuations in measured unemployment. This tends to undermine the argument that, simply due to its peripherality, it must be prone to excessive swings in demand. Its stability may partly be due to the wide spread of the export markets in which it now trades. This dependence would not change quickly under new constitutional arrangements nor would any change be automatic.

This constitutes the status quo for Scotland against which other constitutional arrangements may be calibrated. Because of the volatility of European politics, its stability may be threatened by movements towards further economic integration which may be triggered by the Inter-Governmental Conference in 1996. For the moment we assume that the status quo in economic terms constitutes European customs union but not monetary union. We take up the issue of the monetary union in the next section.

### **ECONOMIC POLICY CONSTRAINTS**

In this section we consider the latitude for independent economic policymaking which would be available to a Scottish government. The main constraints on economic autonomy would be imposed by the EU; these would apply directly to a separate Scottish government, or indirectly (through Westminster) to a devolved government. We are assuming that an independent Scotland would seek membership of the European Union and that a devolved Scottish parliament would be a component of the administrative structure of a state (the UK) which will remain a member of the EU. Notwithstanding the recent difficulties of the relationship between the UK and other members of the EU, we assume that the economic logic in favour of membership will eventually overcome any political opposition and that there are no particular interest groups within the Community which would be implacably opposed to an independent Scotland's membership.

The extent of fiscal control which an independent Scottish government could exert would be conditioned by any moves towards further European integration. The existence of common customs frontiers and the removal of barriers to the movement of labour and capital means there is already pressure on member states to harmonise tax rates. Countries whose rates of personal taxation are well above the European norm may experience high

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rates of emigration. Where indirect taxes differ markedly, inefficient distortions in the location of trade will occur as is evident from the current popularity of purchasing alcohol and cigarettes in France. Those whose rates of taxation of profits are relatively high may miss out on investment opportunities. For Scotland, the main pressure would be that its tax rates did not deviate sharply from the rest of UK, though corporate taxation elsewhere in Europe and in the rest of the world would continue to be of importance in the attraction of inward investment.

The constraints on fiscal policy of a devolved Scottish government would be imposed directly by Westminster. The economic constraints arise because it is extremely difficult to pursue an independent fiscal strategy within a customs union where there is a single currency. This is an appropriate description of the current internal structure of the UK economy. In these circumstances, setting different tax rates may be counterproductive in that economic agents can easily avoid tax (the present importation of alcohol from France being a good example) or it may lead to retaliation by the central fiscal authority. For example, an attempt to provide tax breaks to inward investment by the devolved government would almost inevitably lead to penal fiscal action from the Treasury.

In terms of monetary policy, there are no immediately obvious implications for a devolved government. But if the government of an independent Scotland decided to issue its own currency while remaining within the EU, it would be put under considerable pressure to take part in the movement towards European Monetary Unification (EMU). This would involve the establishment of an independent central bank, and the eventual replacement of the new Scottish currency by the Ecu. For existing members, the position with respect to monetary unification is uncertain, following the difficulties of the Exchange Rate Mechanism (ERM) in 1992. The UK position is particularly unclear, in that the UK government seems to be less committed than other member governments to monetary unification.

For Scotland the options would be to use the pound sterling, with apparently no immediate prospect of it being tied to other European currencies or of being replaced by the Ecu, to establish a separate currency tied to the pound sterling, or a separate currency more closely tied to other European currencies with the prospect of eventual replacement by the Ecu; a freely floating Scottish currency would also be an option, but not one currently adopted by existing small members. Given that Scotland exports a very high proportion of its total production, businesses in an independent Scotland would be likely to argue in favour of having exchange rate stability in order

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that they might more effectively plan their business strategies. But this leaves open the question of stability relative to the rest of the UK, or stability with respect to the rest of Europe.

The Maastricht Treaty of December 1991 set out the timetable for proceeding to full monetary integration. The Council of Economic and Finance Ministries (the ECOFIN Council) was to harmonise macroeconomic policy, and, from January 1994, members were to attempt to keep budgetary deficits at or below 3% of GDP and debt at or below 60% of GDP. Further, public sector bodies were to be prohibited from having overdraft facilities with central banks or from ensuring preferential rates by requiring financial institutions to hold government debt, and central banks were to be prohibited from direct buying of government debt. National central banks were to participate first in the transitional European Monetary Institute (EMI), and then in the European Central Bank (ECB). Under the EMI, interest rates can still be set at the national level, but normally after consultation with the EMI. Before the ECB is established, national central banks are to be rendered independent of their governments. Thereafter interest rates will be determined by the ECB. (It is not clear how ECB independence with respect to interest rate policy is to be maintained, however, since ECOFIN is to have control over exchange rate policy.)

The final stage of moving to European Monetary Union (EMU) with a common currency issued by a common monetary authority (the ECB) is expected to begin in 1996. It will depend on a majority of members satisfying a range of criteria (central bank independence, price stability, low budgetary deficit, stable currency and low long-term interest rates). It is obviously an open question whether the UK would then choose to participate in EMU, and if so whether it would meet the conditions. At present, its fiscal deficit is around 5 per cent of GDP, and is projected to fall below 3 per cent of GDP towards the end of the decade. In practice, only Germany is currently likely to meet the deficit and debt criteria by 1996.

The same conditions would also face an independent Scotland and it would have to choose whether it was willing to accept them. It is unlikely that Scotland would be permitted a special deal in which it could choose which of the conditions to accept. To the extent that the Maastricht plan is acted upon, therefore, a 'Scotland in Europe' scenario would involve constraints on fiscal policy, exchange rate policy and monetary policy. However, there is clearly uncertainty about the timetable if, as at present, member governments do not make their central banks independent, or if they fail to meet the other conditions on fiscal and monetary probity. Sweden, Greece, Italy and

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Belgium have little chance of meeting the debt and fiscal balance criteria within the timetable. The UK is better placed to meet them than all of the other major EU participants with the exception of Germany. Any successor states to the UK would be likely to be similarly well-placed.

Aside from the complications raised by monetary policy, there are other areas where a Scottish government might hope to have a favourable economic impact. For example, it would be surprising if such a government did not put forward its own industrial strategy. Its freedom to pursue such a strategy would be heavily circumscribed by rules on competition at the EU level. These restrict the amount of subsidy that is available, for example, for capital investment or to attract inward investment. The intention is to create a 'level playing field' in which firms in Europe can compete against each other fairly and without favour from their own government.

Similarly, an independent Scottish government would have no control over levels of tariffs and thus could not use these to protect particular industrial sectors. Tariffs would be zero within the EU, but would be set by the Commission for goods being exported from Scotland outside the EU. This would be particularly important to the whisky and electronics industries. These industries would obviously be concerned to have free trade with the rest of Europe but also that the Commission argue strongly on their behalf against the imposition of punitive tariffs in other parts of the world.

However, even though conventional forms of industrial policy based on subsidy or preferential treatment of domestic industries would be proscribed, there might well be scope for policy of a more unconventional nature. The Scottish industrial community is quite small and the linkages within this community and between industry and the public sector are quite well-developed. Bodies such as Scottish Enterprise, the CBI in Scotland and the Scottish Council have, in different ways, fostered links within the industrial community and between industry and the financial sector. Similar links have been viewed as extremely important in fostering economic development in the case, for example, of Japan. How far such success could be replicated in Scotland is open to doubt. But there are possibilities here for policy action which deserve to be explored.

The reaction of the business sector to constitutional change might also form a constraint on constitutional change. This issue has recently been researched by Hood (1995). He argues that current proposals for devolution (which only involve changes in personal taxation) are unlikely, of themselves, to adversely affect either inward investment or industrial development.

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Nevertheless, if competitors or politicians chose to exaggerate its real impact, there might be increased uncertainty amongst the local business community which could only be effectively allayed by setting up clear lines of communication between the business sector and the new Scottish administration. Hood points out that the political climate in Scotland and the UK is typically much more stable than most multinational companies deal with and that present devolution proposals would be viewed by them as relatively minor. Clearly, independence would be a more radical change, with greater uncertainty within the business sector as to its real economic impact. Again, without clear communications between the business sector and the Scottish administration, such uncertainty, if turned into effective pressure on the Scottish government, could act as a formidable constraint on its ability to design and implement economic policy.

### **FISCAL POLICY OPTIONS**

We turn now from the constraints on action to focus on the kinds of fiscal policy which might be possible given the constraints outlined above; possibilities for monetary arrangements are explored in the next section.

The control which the UK central government currently exerts over public expenditure and taxation is almost unrivalled in any other advanced Western economy. Fiscal decisions are spread more widely through the various tiers of central and local government in the USA, Canada, France and Germany. These G7 countries are important examples where financial devolution in some form has already taken place and where the stability of the state, with the notable exception of Canada, is not threatened by the dissipation of decision making across different arms of government. It is also relevant to note that there is no apparent pressure in or on those European states with devolved systems of government to make those systems more centralised as a means of promoting fiscal harmonisation.

A crucial aspect of the devolution debate in Scotland is whether a parliament can be financed in a way which would not threaten the political integrity of the UK. Currently the bulk of the administrative functions of government are financed by a block grant to the Secretary of State from the UK exchequer. The overall size of this grant inevitably reflects the current fiscal stance of the government. Further, priorities at the Scottish level reflect the policies of the UK government and consequently may differ radically from those which a locally-elected Scottish parliament might wish to follow. At local authority level, the scope for independent policy is circumscribed by spending

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assessments made by the Scottish Office which are intended to produce a standard level of service provision in each area, and by the power of the Secretary of State to reduce rates of council tax to 'protect local taxpayers from excessive spending by local authorities'. Thus, the status quo gives little latitude for independent decision-making on matters of public expenditure and taxation within Scotland.

The ability to allocate public spending differently and to be accountable for its distribution are seen as principal advantages of both devolution and independence. But public spending must eventually be paid for through taxation, and it is of interest to know whether sufficient resources are likely to be available to pay for public programmes. At the time of the 1992 election, the discussion of economic policy in an independent Scotland centred round fiscal policy and, in particular, the question of Scotland's budgetary surplus or deficit. This has been given exaggerated importance in the debate, to the exclusion of almost all other aspects of economic policy. There are several reasons why the attention given to it has been exaggerated. First, a single snapshot is not useful since fiscal balance in any economy fluctuates substantially during the economic cycle. From a single observation, it is not possible to determine whether a fiscal deficit or surplus is cyclical or structural in nature. Second, any particular deficit or surplus may be justified as a short-term expedient. For example, during recessions government spending will automatically rise and tax revenues fall so that deficits are more likely during recessions and do not necessarily signify structural imbalance. Third, discussions of the size of the surplus or deficit always seem to neglect its composition. In particular, the balance between current and capital spending is of importance. Though somewhat of an oversimplification, capital spending is more likely to lead to an increase in the overall productive potential of the economy and thus in its ability to repay debts currently being incurred. Fourth, the issue of whether public spending in Scotland should be calculated as that which takes place in Scotland or that which takes place on behalf of the residents of Scotland causes conceptual difficulties in the calculation of the fiscal balance. Fifth, the calculation of fiscal balance is fraught with error. The statistical base from which it is calculated is incomplete and estimates are therefore subject to considerable margins of error. The final reason for wishing to avoid giving undue attention to the fiscal balance is that it is unreasonable to assume that economic behaviour, and thus revenues and expenditures, would be the same after constitutional change as before. Presumably one of the purposes of constitutional change is to promote dynamic change in the Scottish economy, but the nature of such change and its consequences are hard to predict at this stage of the debate.

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This argument has more force the greater the degree of constitutional change at issue.

To examine how a Scottish parliament might deal with taxation issues, we consider first the case of devolution. A separate parliament with its own tax raising powers and responsibility to meet demands for public service from its own revenue would placate complaints of pro-Scottish bias from the rest of the UK. This option is fraught with difficulty, however. First, with demands for public services likely to differ between Scotland and the rest of the UK, which taxes could the Scottish parliament be allowed to vary? To be effective, these would have to belong to the small group from which the government derives the bulk of its revenue.

The scope for variation in VAT is limited because the EU intend that rates of VAT should be brought within two main bands - the standard and reduced rates. Varying corporation tax could be self-defeating because industry would become adept at transferring profits to the rest of the UK. Business rates could be changed, but since Scottish industry has been lobbying for some years to bring its rates down to those levied elsewhere in the UK, any upward movement would result in an adverse reaction from the private sector. Changes in council tax could be used, though revenue from this source accounts for no more than 7 per cent of government receipts in Scotland. National insurance and income tax could be varied, singly or jointly, but if substantially higher rates were introduced in Scotland, pressure to reclassify workers to the rest of the UK might mean that revenue would fall as the tax base was eroded. This process would be reinforced by any increases in emigration resulting from the higher rates of tax. Thus the powers to vary taxes in Scotland relative to the rest of the UK would be constrained both by the economic forces which they might set in train and by the growing influence of the EU on the fiscal policies of member states.

An alternative to allowing a devolved Scottish parliament freedom to raise its own taxes would be to assign some fraction of the proceeds of existing taxation to it. Thus, for example, 10 per cent of all UK VAT receipts might be put at the disposal of the Scottish parliament. Assignment would remove the distortions between Scotland and the rest of the UK which separate rates of taxation might bring, but, as with the block grant, there would be conflict over the share of receipts allocated to Scotland. For taxes such as VAT, EU conventions could be adopted as to where to allocate proceeds and there might be sufficient survey information available to estimate revenue in Scotland. An allocation close to this level could reasonably be viewed as being fair. Assigning taxes in this way would have the advantage of making

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the revenue of the parliament responsive to economic conditions, but even if all taxes were fully assigned to Scotland, there would still be insufficient resources to meet current public spending levels. So long as the UK continues to run a budget deficit, this statement is equally true for the UK as a whole. However, to maintain a consistent macroeconomic policy, the Treasury would want to prevent the Scottish parliament from issuing debt. Without this power, the parliament would therefore require a supplementary block grant to balance revenue and expenditure. Thus, assigning tax revenues is little different from the current block grant. The parliament would have no ability to vary revenues because it would have no control over the rates at which taxes were levied which could lead to a sense of impotence and frustration. The supplementary block grant would be a highly transparent transfer to Scotland from the rest of the UK.

None of the methods of allocating resources to Scotland discussed above appears ideal. The block grant is non-distortionary but leads to a lack of accountability and can always be criticised as being based on arbitrary judgement rather than need. Assigning taxation may result in less distortion but is likely to require a supplementary block grant. While a parliament might demand powers to vary existing taxes, the scope for doing so is limited both for economic and institutional reasons. Further, if Scotland were the only area of Britain to be given a parliament, the lack of symmetry of treatment would increase the potential for conflict with other areas. Political difficulties tend to be greater where the demand for devolved powers varies across different parts of the country. The case of the relationship between Canada and Quebec provides one example, though the parallels with the Scotland-UK relationship are limited.

In the context of devolution, one possible means around this impasse would be to retain some elements of the schemes previously mentioned so that some limited fiscal autonomy and accountability could be transferred to a parliament. It would involve assigning taxes to Scotland where appropriate, but topping this up with a supplementary block grant on the basis of need. If the scheme were introduced in the UK as a whole, tax revenue could be 'top-sliced' to create a fund from which resources would be redistributed to poorer areas. Need would be assessed over a fairly long time horizon, five years or more, so that the distortionary effects due to different timings of the economic cycle across regions could be eliminated. Net borrowing outside this period would not be permitted. Finally, small variations in tax rates would be permitted to allow the parliament some latitude in its spending plans. This would create a much more transparent link for the electorate between local taxation and the costs of local public services. It would also

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generate an incentive for a regional parliament to increase revenues for those taxes assigned to it. Nevertheless, the autonomy which the devolved parliament would enjoy would be strictly limited. So long as the Treasury is charged with the duty of maintaining tight control over UK macroeconomic policy, it is difficult to envisage any substantial increase in this autonomy, particularly as increasing integration of the European economy is building up pressure for fiscal harmonisation rather than fiscal diversity.

Now consider taxation by an independent Scottish government. Independence would apparently bring freedom from fiscal controls imposed by the UK Treasury, but there would be no block grants from the rest of the UK. Some EU funding might still be available to areas such as the Highlands, but no more general support would be likely unless Scotland's economic position worsened markedly with respect to the rest of Europe. The Scottish government would nevertheless need to ensure that its tax rates did not increase markedly above those of our closest trading partner - the rest of the UK- to avoid substantial outflows of capital or labour. But an independent Scottish government - unlike a devolved parliament - would be able to issue debt to finance a deficit, just as existing EU members do.

The scope for borrowing allowed by Maastricht and the monetary environment more generally also affect fiscal policy. If Scotland joined the EMU, interest rates would be set at an EU level and would not necessarily appropriately reflect inflationary or recessionary pressures in Scotland. Thus, interest rates might be set at a high level in Europe to combat inflation in France and Germany but this could add to unemployment in Scotland if the level of demand there was low. The Scottish administration would wish to cut taxes to prevent unemployment increasing but the required adjustments would be large since, due to the openness of the economy, much of the tax cuts would be spent on goods produced outside Scotland. Hence there is a possibility that the size of the government debt in Scotland would grow rapidly, coming up against the limits set by the EU.

However, this is a gloomy scenario predicated on the assumption that demand in Scotland is relatively low compared with other EU countries. Weakness in demand could occur if Scotland joined the currency union at an uncompetitive rate. It could also occur if the timing of recession in Scotland's non-EU markets differed from those in the main EU economies. The former would result in long-term structural problems where unemployment could only be kept down by constantly increasing government debt. The latter is a cyclical problem which would even out when the non-EU markets experienced higher levels of demand.

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Although economic relationships with the EU and the rest of the UK would constrain fiscal policy in an independent Scotland, it is worth bearing in mind that the Scottish government would have an input to the setting of EU economic policies. However, an important exception to this could be monetary policy, where the influence of individual governments is likely to be muted if a European Central Bank takes over the setting of the monetary framework as we shall see in the next section.

### **MONETARY POLICY OPTIONS**

The importance of monetary policy has been emphasised by recent upheavals throughout Europe, with substantial currency realignments. What also has become clear is that international capital markets are far more powerful than individual governments in determining the relative values of currencies. This was clearly demonstrated by the abortive efforts of the UK government to hold sterling within the ERM. The foreign currency reserves which the government of one of the top seven industrial nations used as its main weapon to maintain the value of sterling were easily brushed aside by the concerted action of the currency markets. Other countries, such as Italy and Sweden, have suffered equally humbling reversals.

The traditional tools of monetary policy would not be available to a devolved Scotland, although there are some other possibilities which will be explored below. But what implications do these events have for the discussion of monetary policy in an independent Scotland? First, small nations are even less likely to be able to restrain market sentiments than large ones with substantial currency reserves. Capital controls are likely to be ineffective as traders are now much more ingenious at circumventing them. An independent Scotland would wish to retain financial services as a major industry employing a significant share of the workforce. But this industry would be likely to have difficulty operating efficiently in an environment where capital movements were restricted. Given that there seems little likelihood of a reduction in the amount of free-floating capital moving around world money markets, the activities of an independent Scottish government are likely to be constrained by market sentiment. This would be likely to influence Scottish economic policy whatever the constitutional arrangements.

A fundamental issue of monetary policy which would immediately confront an independent Scotland (but not a devolved Scotland) would be whether to have a separate currency, say the Scots pound. As pointed out earlier, the existence of a separate currency could be only temporary if Scotland were to

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join in the EMU process. But, given the uncertainties with that process, it is worthwhile considering the case for a separate currency, at least as an interim possibility.

Whether a currency's value changes or not depends on the state of the balance of payments; the currency appreciates if there is a tendency to surplus and depreciates if there is a tendency towards deficit. A separate currency then has the advantage of adjusting to any payments imbalance. But there may be a tendency for payments into Scotland to exceed payments out, or vice versa, even if there is not a separate currency. So the question becomes whether a changing exchange rate would be preferable to existing forms of balance of payments adjustment.

Adequate information is not available on the current state of the Scottish balance of payments. There are however some indicators which allow us to guess at its structure (see Dow, 1991a). First, while we do not know from year to year if there is a trade deficit or surplus, the new input-output table for 1989 indicates a substantial trade deficit for that year. In addition there is probably a net transfer from Westminster which offsets a trade deficit, or adds to a surplus. The rest of the balance of payments is made up of other transfers (which are difficult to identify) and capital flows. With Scotland's high saving ratio, preference for relatively liquid assets and relatively low borrowing, there must be a strong tendency towards capital outflows; this total is offset by inflows associated with inward investment. When there is a large trade deficit, the difference must be made up by a combination of increased flows from Westminster and by inflows of borrowing or the proceeds of sales of assets. On balance, there is probably a tendency towards deficit on the capital account (aside from capital inflows required to balance payments); how this would be affected by independence would depend significantly on the attitudes within financial markets to the returns expected within Scotland, and also on financial behaviour within Scotland. Since the pattern of financial behaviour in the past has reflected a history of lack of confidence within Scotland, it is possible that independence might bring with it a fundamental change - a greater willingness to borrow and to invest in Scotland for example, which would encourage capital inflows and economic development. This in turn would provide financing for any tendency towards trade deficit, in the absence of transfers from Westminster.

Whenever there is a tendency in Scotland towards balance of payments deficit, there is a range of adjustment mechanisms which come into play to ensure payments balance. Suppose, for some reason, a deficit arises because Scottish exports became less competitive. Incomes fall, reducing imports.

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Outflows of labour can cure the resulting unemployment, and further reduce imports, restoring trade balance. But, aside from the social consequences of migration, this would not necessarily restore competitiveness if it were the young, skilled and enterprising elements of the labour force which emigrated. With respect to capital flows, too, two views may be taken. Branch plant activity in the uncompetitive sectors could move elsewhere increasing average competitiveness in Scotland (a long-term capital outflow) and the deficit could be financed by borrowing (a short-term capital inflow). On the other hand, the spin-off effects of branch-plant closures could further reduce Scottish competitiveness, encouraging short-term capital outflows, i.e. worsening the balance of payments problem. In other words, the 'automatic' adjustment mechanisms might not work very well in the case of a deficit, and may create a vicious circle. However, if the deficit arose because of high imports due to an expanding economy, the emigration would not occur, and capital inflows to finance the deficit would only be temporary, until export growth restored payments balance. In this case, adjustment is not even necessary.

Whenever Scotland has a tendency towards surplus because of strong export growth, for example, under current arrangements, automatic adjustment mechanisms come into play in the form of increased incomes and thus imports, immigration of young, skilled workers, and the opening up of new branch plants. In the case of a growth-generated surplus, therefore, the automatic adjustment mechanisms may create a virtuous circle. If the surplus is due to weak imports in recessionary conditions, then again adjustment as such would not be required; exports and capital flows could be expected to weaken in line.

How would a change in the value of the Scottish currency compare as an alternative adjustment mechanism? With a separate currency, the first effect of a deficit would be a fall in the value of the currency, which would automatically make exports cheaper and imports more expensive; in the case of a surplus, the currency appreciation would make imports cheaper and exports more expensive and the other adjustments might not be necessary. Whether this feature of a separate currency is really necessary and would work is open to question. The first consideration is whether demand for Scottish exports and Scottish demand for imports are price elastic, i.e. respond to price changes. The Marshall-Lerner condition (see Williamson and Milner, 1991, pp.196-8) states that a devaluation will not cure a trade deficit, or a revaluation cure a surplus, unless the absolute sum of these two elasticities is at least one. The need for exchange rate changes is likely to be greatest if the domestic economy is unbalanced in some way relative to other

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economies, as Scotland would be as a result of the oil sector. An oil price change could induce a trade imbalance which could be corrected by an exchange rate change. (Without the Continental Shelf, the Scottish economy's structure is not sufficiently dissimilar to the rest of the UK to expect sectoral developments to cause balance of trade problems.) But an appreciation in the case of an oil price rise could inhibit exports from other sectors (the 'Dutch disease'); the alternative forms of adjustment to a trade surplus in any case seem quite attractive. If a tendency to surplus is expected, therefore, a separate exchange rate could prove to be a liability.

A separate currency would therefore seem more desirable if the outlook for the Scottish economy were pessimistic: the alternative adjustment mechanisms can cause a vicious circle, while a depreciation has a better chance of improving the balance of payments. However, even if the argument is persuasive that a variable currency is desirable, the question remains as to whether it could achieve its desired objective. If product and labour markets in Scotland are highly integrated with the rest of the UK, then real prices and wages will continue to be established on a UK-wide basis. Suppose Scotland were to have a balance of trade deficit with the rest of the UK, and the currency depreciated accordingly. In order to maintain prices and wages at their UK-equivalents, they would have to rise, eliminating the competitive advantage otherwise conferred by the depreciation.

This situation can be described as one where a separate currency is not feasible. The risk it poses is that of demonetisation, i.e. that the value of the Scots pound became so irrelevant to day-to-day transactions that it ceased to be accepted as money. While a separate currency could bring the advantages of prestige and enhanced identity in international markets, the converse effect would follow demonetisation.

Therefore, while a case might be made for a separate currency with varying value as a mechanism for payments adjustment, particularly if Scotland were prone to a deficit, the case is virtually nullified by the fact that Scotland is already so highly integrated with the rest of the UK that the mechanism would never have a chance to work. To this could be added the disadvantages for trade of having the barrier of a separate currency of varying value. Transactions with the rest of the UK would involve the costs associated with changing currencies, and the costs of dealing with the uncertainty attached to future exchange rates. For an economy the size of Scotland, this barrier could be significant and itself cause demonetisation.

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A separate currency with value fixed absolutely with respect to the pound sterling is another matter. The currency would not itself constitute an adjustment mechanism. Nevertheless it is possible that it could facilitate other adjustment mechanisms. In particular, if it were the case that capital flows were causing rather than curing payments problems, then a separate currency would allow measures to be introduced to redirect capital flows. Indeed without a separate currency it is very difficult to gather the information required to identify the nature and direction of cross-border capital flows. For Scotland to introduce exchange controls now in a climate of monetary integration in Europe would be very difficult, although not impossible. But consideration of any form of financial policy would be extremely difficult without better information than is currently available on capital flows.

Some transaction costs would arise from a separate currency with value fixed relative to the pound sterling. But these would be much less than for a pound with varying value. At the same time, as long as demonetisation could be avoided, the benefits would accrue of the prestige and national identity associated with a separate currency. Further, issuing currency yields seigniorage (the difference between production costs and market value); this would constitute an additional source of revenue, which would offset the organisational costs of setting up a separate currency. Finally, independence would presumably entail a sharing out of assets associated with the current UK central banking operation, notably current holdings of gold and foreign exchange reserves.

If the Maastricht plan is followed through, monetary unification in Europe would rule out the possibility of separate currencies, even with exchange rates irrevocably locked. The aim set out at the Maastricht Summit is to replace national currencies with the Ecu as the common European currency. If the arguments for a separate Scottish currency are accepted, the question remains as to whether the disruption associated with establishing a separate currency is justified, if its existence came to an end with monetary union. However, Maastricht also set out plans for the establishment of a European central banking system which would involve the participation of member country central banks. The disruption then might be justified as a necessary cost of establishing an independent Scottish central bank which could then participate in Europe on a par with other central banks. Without a separate currency, it is possible that the EU would not recognise a Scottish central bank; Scotland might then be represented by the issuer of its currency (the Bank of England), or not at all.

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Closely associated therefore with the issue of a separate currency are questions regarding the feasibility of and possibilities for a Scottish central bank and monetary policy. Discussions of central banking and monetary policy are frequently limited to the goal of price stability. The usual type of discussion then focuses on the central bank's control of monetary aggregates and the consequences for the general price level. This indeed has been the focus of Maastricht. The consequence of this narrow perception of the role of central banks is that the plan entails national central banks being made independent of their governments, and the European Central Bank being independent of other EU bodies. At the moment there are no plans to proceed along these lines in the UK. But if Scotland were to go along with the Maastricht plan there would be no possibility of an independent monetary policy and the rationale for establishing a central bank independent of government would not be altogether clear.

In the meantime, the prior questions are whether this narrowly-defined monetary policy is necessary and feasible for a Scottish central bank. The first issue is whether the monetarist argument is correct that inflation is caused by changes in the money supply, or whether the reverse is the case. While one of the advantages of a separate currency is seen as the capacity to choose a different inflation-unemployment trade-off than other countries, it is not at all clear that monetary control is the tool which would allow such a choice to be made. It can be argued for example that the reduction in inflation in the UK in the 1980s was due to fiscal deflation rather than monetary control. From this perspective, the discussion of price stability in Scotland would refer more to fiscal policy than monetary policy. But it is unlikely that Scotland could sustain a markedly different inflation rate than the rest of the UK in any case, given the highly integrated nature of product and factor markets.

Further, a Scottish central bank would be unable independently to control the money supply. It is generally agreed (on the basis of Mundell's original argument (1962)) that independent monetary policy is impossible for a small open economy with a fixed exchange rate (or indeed common currency). But even with a variable exchange rate the scope would be strongly limited. It is now an increasingly widely-held view in any case that central banks cannot control the money supply given the nature of modern banking systems, and that attempts to do so are likely to be highly disruptive (see for example Dow and Saville 1988, and Goodhart 1994). This argument indeed has a long history, including the arguments by the Scottish bankers against the introduction of the 1845 legislation which for the first time introduced

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quantitative controls on the credit expansion of the Scottish banks (see Checkland 1975).

The primary means by which central banks attempt to control monetary aggregates is via interest rates. If the central bank wants to reduce the amount of cash in the banking system, they can either manipulate interest rates through buying and selling assets (these could be government or commercial bills or bonds), or by altering the rate at which the central bank lends reserves to the banking system. For a Scottish central bank to do the former would require a distinctively Scottish market in the assets being bought and sold. This might be feasible if the Scottish central bank were to build up a market in Scottish government bills and bonds, in its role as manager of government finances. It must be remembered, however, that Maastricht, if implemented, would prohibit such a role. But in any case European monetary integration means that it will become progressively more difficult to isolate national bond markets, so that the effort involved in building up active bond trading in Scotland would scarcely be warranted.

The issue of using bond markets for monetary control purposes is quite separate from the question of whether Scottish borrowing instruments could or should be issued. Indeed, since there is no obvious reason for a Scottish government to tie itself to a balanced budget, the normal expectation would be that Scottish bonds would be issued from time to time. These could be negotiable bonds issued on the international market, or non-negotiable savings bonds issued to local residents. The interest rate on these bonds would have no direct effect on borrowing costs for Scottish business.

The alternative mechanism for a central bank to influence interest rates is the interest rate charged to banks for borrowed reserves. Manipulation of interest rates through the lender of last resort facility would, like open market operations, require a diversion of Scottish banks' attention from the London money market and the Bank of England. There is little chance of this occurring without a separate currency. But it would also require a Scots pound whose value was allowed to fluctuate to have an interest rate policy with some independence. Even within the ERM there were interest rate differentials. But then national interest rates become driven by the force of short-term capital flows attracted by interest rates which are high relative to the expected value of the national currency. Scotland could only maintain interest rates lower than elsewhere if the exchange rate were more likely to appreciate than depreciate. Interest rates persistently lower than the rest of the UK would be difficult to sustain, and would be dependent on the caprices of international financial markets. The experience of Canada and the US, for

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example, demonstrates how closely interest rates between close neighbours can be tied by market forces, even with separate currencies and separate banking systems. Indeed, since so many financial institutions in Scotland operate UK-wide, it would be extremely difficult to prevent UK borrowing being channelled through Scottish branches and deposits through English branches; if the purpose were to help Scottish business, the object would be defeated. In other words a separate currency as a vehicle for an independent monetary policy would represent a highly risky strategy, possibly even bringing about higher interest rates in Scotland. Alternative means of supporting Scottish business would have a better chance of success. In any case, if Scotland were to follow the Maastricht plan and made its central bank independent, there would be no mechanism for a Scottish government to influence interest rates.

But interest rate policy is only one aspect of the potential influence of a central bank. Indeed, if credit creation is determined more by decision-making within the private sector than by central bank control, then monetary policy needs to be recast in any case. Given the high degree of sophistication of financial markets which allows this independence from traditional monetary controls, attention should perhaps be addressed more to prudential controls to ensure the soundness of the financial system, and to other aspects of business finance than the cost of credit (see Dow (1991b) for a statement of this argument with respect to Scotland).

Prudential control is an issue of tremendous importance in the global context and immediately in the context of blending the supervisory functions of the different members of the EU as the European financial system becomes ever more integrated. It is possible that a Scottish central bank could create a market niche in supervisory control, benefiting from the current 'flight to quality'. The Scottish financial system has an international reputation for prudence. Pre-1845 the free banking system in Scotland policed itself with the Bank of Scotland, the Royal Bank of Scotland and the British Linen Bank acting with considerable success like a central bank. If a new Scottish central bank could devise a superior form of bank supervision, then that itself would attract international financial business. The BCCI episode has demonstrated the serious dangers involved in inadequate policing of financial institutions, and the next few years should see an increased awareness among financial investors of the importance of identifying institutions which are adequately policed. While the Scottish tendency for financial prudence at times may have retarded economic growth, it could be turned to tremendous advantage if encapsulated in a 'safe' regulatory environment. It would certainly be surprising, within an integrated European financial sector, if funds were to be

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withdrawn from Scotland because of independence. If the Scottish financial sector and its supervisory environment were to be marketed effectively, an increased inflow of funds would be more likely.

In terms of its relationship with Scottish business, another feature of the Scottish financial sector which would present opportunities for a central bank is the unusual degree of cohesion within the sector. Scotland is fortunate in already having a strong financial sector; most peripheral economies must devise protective measures, like preferential tax treatment, in order to build up to that strength. Although it is difficult to identify hard evidence to substantiate them, public statements have been made on a variety of occasions to the effect that Scottish banks have a different ethos from their London counterparts. This ethos is fed by the social and cultural cohesion within the sector. These are under threat from the ever-increasing degree of international financial integration. But there may well still be sufficient cohesion to allow what used to be a very powerful tool of monetary policy for the Bank of England - moral suasion.

Moral suasion might be employed to encourage direction of credit towards particular sectors or regions or types of enterprise. This can be justified on its own merits, but also by the fact that otherwise banks are caught by a fallacy of composition. One bank expanding credit alone within a particular locality for example is vulnerable to the possibility of the economic decline of that locality and the associated multiplier effects on the bank's clients. Many banks supporting the locality financially, on the other hand, would be reinforcing the value of each other's loans, in that decline would be less likely as a result of financial support, and success could breed success through the multiplier effect.

Such a policy for a central bank would make most sense if it were conducted as part and parcel of industrial policy. The Japanese model provides an example of co-operation and mutual support between the business, financial and government sectors. Thus encouragement of lending to a particular sector would be part of a policy package designed to induce expansion of the sector. The chances of individual banks' lending being secure and profitable would be enhanced in such an environment.

The role for a central bank being explored here is therefore one of co-operative, collective action rather than the imposition of controls. The central bank could indeed act as a promoter of the financial sector as well as introducing the macro-industrial policy element into decision-making outlined above. Fiscal incentives might be considered to promote particular

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elements of the financial sector. There have been various examples of measures in other countries to promote the international profile of a domestic financial sector. An independent government with fiscal powers could explore a range of possibilities with the financial sector which would suit the particularities of the Scottish situation. Particular measures, as introduced in Quebec for example, could be adapted to the Scottish situation (see Dow 1990, 1991b). But the point being made here is that the process by which measures should be designed and implemented should be the outcome of a consultative process among all the interested parties in Scotland.

The possibilities for a Scottish central bank being explored here envisage close co-operation between the government, the central bank, the financial sector and the business sector. Indeed, monetary influence through moral suasion, information sharing and discussion would be open to a devolved government, just as to an independent government. The agency need not be called a central bank. In fact, it might be advisable not to use the term 'central bank' since the approach being proposed here for such an institution is absolutely at odds with the European plans for independent central banks; we are proposing an explicitly co-operative approach between government and the central bank (and other parties). In any case, this institution would not be free to operate an independent monetary policy as conventionally understood (i.e. interest rate control, etc.). It could go by a name such as 'Finance Scotland'. Careful consideration would have to be given to designing the best institutional structure, in order to allow participation in European monetary policy-making and at the same time preserve the latitude for the kind of co-operative activity outlined above.

### **CONCLUSION**

In this paper, we have examined the options for economic policy-making both in an independent Scotland and in one with a devolved parliament, within a Scotland-within-Europe scenario. Harmonisation of regulation and fiscal measures within Europe, plans for European Monetary Union and the power of global economic pressures significantly limit the scope for distinctive Scottish economic policy. Nevertheless there are possibilities which follow from the logic behind the independence and devolution arguments. If there is something distinctive in Scottish society which independence or devolution is designed to foster and harness, then this distinctiveness should allow a distinctive role for the state despite international constraints. In particular, the combination of distinctive institutional arrangements and economic behaviour within a co-operative

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ethos can allow for a partnership role for government which could have dynamic effects on the Scottish economy.

Thus, for example, a central banking institution in an independent Scotland could further promote the co-operation which already is present within the financial sector and between the financial sector and government agencies, and make an explicit connection between policy towards the financial sector and industrial policy. Further, Scotland's reputation for financial probity could be captured in a system of bank supervision which could further enhance the international standing of the Scottish financial sector. Such an institution could not be called a central bank, given the strictures of the Maastricht Treaty (notably that central banks be independent of government). But there would be strategic advantage to having a central bank to represent Scotland in the European System of Central Banks; along with this it has been argued here that there could be strategic advantage to having a separate currency (even if only as an interim measure), although it should be fixed in value to the pound sterling.

We have not gone further in exploring possible economic policies in detail. One of the main imports of the argument has been that most of the possibilities which would be open to a Scottish parliament would be based on distinctive Scottish behaviour and institutions, and would arise from a co-operative process between relevant interest groups. In other words, once the constraints on policy-making are recognised, the detail of policy possibilities should be the outcome of a process which has not yet started. It follows that, for the debate to progress, there needs to be much more discussion of what that process might be, and the types of developments which all interest groups would like to see if there were to be constitutional change.

Fiscal constraints would be important, as for any governmental system. We have developed here an argument for a system for a devolved parliament to be funded by a combination of assigned taxes, with the possibility of small variations in rates, and a supplementary block grant on the basis of need. An independent parliament would be constrained by tax harmonisation in Europe and borrowing constraints imposed by the Maastricht Treaty, but there would still be latitude for some tax variation, and for some borrowing to finance deficits.

But we would like to emphasise that there is a limit to how far the fiscal balance under any scenario may be predicted. Most predictions are based on projecting the past pattern of revenues and expenditures into the future. Even this exercise is problematic, but it misses entirely the point that the purpose

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of constitutional change is presumably to ensure that the future is not like the past. Our aim here has been to try to encourage the debate to steer away from static fiscal balance arguments, and towards a discussion of the types of economic change which could be the consequence of constitutional change.

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