
Economic Perspective 2

INDEPENDENCE: THE OPTION FOR GROWTH - A REVIEW

by Paul Draper

Department of Accountancy and Finance
University of Strathclyde

Aimed at the Scottish Financial Community "Independence: The Option for Growth" by Robin Angus* claims to provide both "a discussion of the pros and cons of independence" from the perspective of an observer working within the financial services industry and "a number of reforms which an independent Scottish government could consider introducing to facilitate growth in the financial services industry". Besides noting from the 'discussion' of independence the three "great" advantages the financial community would have in an independent Scotland: the fund of goodwill towards Scotland; the eagerness of a Scottish government to see the financial services industry thrive and expand; and because of its importance, a strong voice in shaping government policy, "It could ask for and could expect to get any tax or other incentives which it might reasonably be possible for it to receive"; and suggesting that these 'advantages' are merely part of a wider set of beliefs and assertions which are largely untestable except by independence, we concentrate in this Review on his discussion of reforms that could facilitate growth. Three areas are of particular interest: the opportunities for investment trusts, the creation of a national investment bank and his suggestions for the private savings market.

There is little doubt that investment trusts have been the Cinderella of the financial services industry. Hampered by legal restrictions they have been unable to compete effectively with unit trusts and yet have been deprived, arbitrarily at times, from exploiting the advantages of their status as companies. The existence of a discount has encouraged predators and put at risk the continued existence of much of the sector and consequently a significant part of the small

independent fund management industry in Scotland. Opinions vary on the appropriate solutions to the problem. Angus suggests improvements in the law to allow companies to buy in their own shares more easily, the suspension of voting rights in a bid situation, a greater disclosure of interests in the ownership of a company's share capital and to give investment trusts the freedom to advertise. A number of tax measures are also proposed.

Whilst disagreeing with his diagnosis of the causes of the investment trust industry's problems, there is for example no statistical evidence to support the belief that institutional holdings depress the market price of the trusts, he is right to try and promote more discussion of the issues many of which are of wider significance than merely the investment trust sector. We would all like to see bids for a company being "an informed and constructive debate about a company's future" so that temporary suspension of voting rights of shares which changed hands following announcement of a bid might be a welcome reform. The consequences for the liquidity of the market at the time of the sale and for the firms shareholders, however, would merit further consideration. Fuller disclosure of share stakes would also be generally welcome but it is not clear that his suggestion that all the costs of a bid should be borne by a bidding firm would be beneficial. Such a system might well deter bidders even though the existing shareholders generally benefit from bids. Would a policy of this type be genuinely in the interests of the shareholders?

Robin Angus is good with words. He graphically paints a picture of investment trusts under attack from vicious predators who "care nothing for the

good of the Scottish financial community or for the interests of the small shareholders" but it is not clear that the investment trust managers themselves are unduly concerned about either of these two goals. Management income and growth are of far more concern than the small shareholder. Why haven't investment trusts put investment management contracts out for tender to the best bidder? The reality is that investment trusts are captive to management groups and it is the management groups that are primarily under threat from predators for their trusts. A provision in management contracts for periodic review of the continued existence of a trust and the free movement of investment management contracts would almost certainly reduce the discount. It would not require legislation and is wholly in the hands of the industry.

His proposals on advertising also merit consideration. The existing restrictions stem from a desire to prevent companies from promoting their own shares. Do we really wish to allow trusts to spend investors money on increasing the price of their own shares? The problem, of course, is that to compete with other investment vehicles, particularly unit trusts, investment trusts need the ability to advertise but might it not be better to place restrictions on unit trusts rather than allow investment trusts unlimited freedom? A level playing field does not require unfettered ability to advertise. Angus is correct in identifying a problem but his solutions are from the perspective of the investment trust industry and not that of its shareholders.

The suggestion of tax reforms aimed specifically at improving the current situation for investment trusts is more problematic. Whilst not wishing to dispute the validity of the suggestions they hardly seem relevant to a document that suggests the existence of "a comfortable Budget surplus of revenue over expenditure". If this is true substantial tax reforms might be expected.

And yet, this encapsulates a severe problem of the paper. The scenario surrounding independence is never clearly stated. Other policy documents suggest that the Scots pound might be related to the ECU but no attempt is made to set out the legal and constitutional framework in which the financial sector would operate or the consequences of differences in exchange rates. It is implicitly assumed that everything would remain unchanged except where specifically amended by a Scottish

government, but this is unlikely to be the case. Could we realistically assume that the English government would sit back and see Scottish financial companies being offered significant tax and legislative advantages in order to secure a large share of the English market? It is inevitable that national governments would act to protect their own interests so long as they have the discretion to do so, and if they don't have this discretion because of the EEC for example, then there is no attraction in independence. It is paradoxical that the paper should wish Scotland to remain part of Europe, a Europe that is working towards integration, but wish to see a disintegration of existing relationships within the UK. "As long as Westminster retains control of any part of Scotland's affairs, there will inevitably be recurring periods of uncertainty, confusion and acrimonious debate." For Westminster read Brussels?

The Company of Scotland would fulfil the role of a national investment bank but be a listed company, financed by private capital and run on commercial lines. Its role would be to invest on a commercial basis in new businesses in Scotland or to supply fresh capital to existing businesses which wanted to expand. Capital for the Company would be raised by a variety of financial instruments including stepped preference shares, ordinary shares and warrants and it would have a Board of Directors chosen to reflect its status in the community. The Company would combine the profit motive and a sense of social responsibility and would tap private capital at present "on deposit in banks and building societies or tied up in National Savings, gilt-edged stock or other fixed interest securities".

Why should a national investment bank be necessary? Would it take on investment the private sector did not want and if it did could it be run on commercial lines? The paper is silent on such issues. It proposes an innovative financial structure but takes for granted the need for such a bank, its methods of operation and the requirement for it to be run on commercial lines. In addition, it implies that there are no costs from redistributing funds from National Savings or banks to the new investment bank; the government presumably never has any funding problems! The paper also, perhaps inadvertently, throws light on the current role of the Board of Directors of investment trusts. There appears to be no need for financial or economic competence: position in

the community is all. Confirmation of what many have suspected? The Company for Scotland may be a desirable creation with an important and useful role to play. There may be a need for a national investment bank. The case remains to be 'made however.

Improvements to the savings market also figure in Angus's proposals. A Scottish Financial Services Act, "stripped of its inadequacies and clumsiness" will bring a cheer from many hearts, although it is not clear that consumers would identify the same areas for change as the financial services industry. "A system of regulation which was at once more reassuring to the investor and more user friendly for the honest investment practitioner" is probably no more achievable than counting the number of angels on a pin head and besides what of the dishonest investment practitioner - isn't this why the elaborate system is necessary?

Scottish PEP's and savings allowances with generous tax are also commended, no mention is made of the costs and potential distortions of such schemes - implicitly what is good for the investment industry must be good for the economy and welfare of the people, as are cheaper and easier security dealing costs. The reader may be

surprised that a direct government subsidy to achieve this objective is not the only possible way suggested of achieving this aim.

Overall, the paper is far from convincing. It is well written and passionately argued but the case presented is one sided and incomplete. The paper does not provide an adequate framework for discussion and argument. The proposals for investment trusts are worth considering further but even here the author is partisan and prejudiced. He does not start from a consideration of what might be desirable for the economy, or for the shareholder, but rather assumes that "investment trusts are a good thing" and should be further encouraged to grow and pay substantial fees to their managers. He may be right but please let us have some evidence to support the assertions.

Footnotes

- * "Independence - the option for growth; an open letter to the Scottish financial community" by Robin Angus, Scottish Centre for Economics and Social Research, 27 Hope Terrace, Edinburgh, EH9 2AP