



The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

FINANCE COMMITTEE

Wednesday 25 June 2014

Session 4

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FINANCE COMMITTEE
21st Meeting 2014, Session 4

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*John Mason (Glasgow Shettleston) (SNP)

COMMITTEE MEMBERS

*Gavin Brown (Lothian) (Con)

*Malcolm Chisholm (Edinburgh Northern and Leith) (Lab)

*Jamie Hepburn (Cumbernauld and Kilsyth) (SNP)

*Michael McMahon (Uddingston and Bellshill) (Lab)

*Jean Urquhart (Highlands and Islands) (Ind)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Professor David Heald (University of Aberdeen)

Rachel Holmes

Professor Alan Trench

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The James Clerk Maxwell Room (CR4)

Scottish Parliament Finance Committee

Wednesday 25 June 2014

[The Convener *opened the meeting at 09:30*]

Decision on Taking Business in Private

The Convener (Kenneth Gibson): Good morning and welcome to the 21st meeting in 2014 of the Scottish Parliament's Finance Committee. I remind everyone present to please turn off mobile phones or other electronic devices.

Our first item of business is to decide whether to take in private items 3, 4 and 5. Do members agree to do so?

Members *indicated agreement.*

Scotland's Public Finances Post-2014

09:30

The Convener: Our second item of business is to take evidence for our inquiry into Scotland's public finances post-2014. We have two panels of witnesses to hear from today, the first of which consists of Rachel Holmes. Good morning, Rachel, and welcome to the committee.

Rachel Holmes: Good morning.

The Convener: Thank you very much for coming along and for your written submission. As members have copies of your submission, we will go straight to questions. I will open with some questions, and then I will widen out the session to include other members.

In your submission, you say:

"there is little opportunity for change to suit the specific circumstances be they economic, demographic or social, of Scotland."

You also say:

"With a no vote there is little further discussion to be had in terms of the Scottish Parliament".

Do you feel that Scotland has the required employment, immigration or fiscal tools to boost the size of the working-age population?

Rachel Holmes: In my view, no. If we are talking about the pensions brief, which I know has been quite a large part of the committee's work, for us to do anything to address any of the issues that have been raised around pensions we would need the powers to which you refer. If there is criticism of Scotland having a larger ageing population than the rest of the United Kingdom, I would argue that that presents a case for doing something about the situation. It would involve a range of measures, one of which is, of course, control of our immigration policy, which we do not have.

Given what I have read in various briefings and seen on the television news, it is my view that immigration is a very different political topic here from what it is in the south of England. There is a different political agenda here, although it is not completely different. I would argue that population densities and existing levels of immigration in the south of England are different from those here, so it would benefit Scotland at least to encourage educated, talented, ambitious young people to come to Scotland. I do not see how we can do that with current immigration policies.

The Convener: You also say in your submission:

"The UK is low in rankings of countries in terms of provision for pensioners. Many countries, often those with small populations, do better."

I understand that around 30 million people of working age in the UK are undersaving for retirement. In your view, what decisions by successive UK Governments have contributed to the pensions crisis? What could have been done differently?

Rachel Holmes: I would argue that the pensions crisis existed before the financial crisis of 2007-08. It has been brewing for some time as a recognised problem. It goes back as far as 1997 at least—which is when I became interested in these topics—to what I think was Gordon Brown's first budget, which took taxation from dividend income earned by pension funds. I believe that, over the years, that has been quite a substantial hit on the growth of those funds. It is one element that has hit pensions, and it goes back quite a way. However, successive UK Governments have not revoked that taxation, which some people have called a raid on pensions.

I would argue, too, that one of the newest reforms has not been helpful for pensions. That is the reform whereby people who have saved into a private pension scheme all their lives and have had the tax relief on that at the highest rate and the additional rate—people who are at the higher earnings levels—are now able to cash in their lump sum, take it in its entirety and spend it however they want. They have had tax relief on pension savings, which they will not be forced to put into an annuity. That has been described not by me but by the Organisation for Economic Co-operation and Development and various pension bodies in various terms, including "reckless". It has been called the "Lamborghini reform": people can take the money and spend it how they want. There is no provision requiring them to take an annuity, which is problematic for the future. Although the Government gets income tax revenues up front from that lump sum, there is no longevity to those revenues as there is with an annuity that is paid down and taxed. We have lost longevity in the tax income.

Another aspect, which I believe is to do with fairness, is the way that our tax system works for pensions. We have a fairly progressive tax system in the sense that it taxes different income bands at different levels. If you discount the lower savings rate, you could argue that having the basic, higher and additional rates is progressive at some level, but it becomes regressive when you start applying the approach to tax relief. It means that people who earn the most are capable of getting the most relief. People can save into a pension fund and get relief at 40 or 50 per cent. Arguably, when there are poorer people who cannot afford to save at all, there is an ethical, moral, fairness or equality

argument for an element of redistribution to even out the ever-widening wealth gap between the poorest and the richest in this country. For me, that is a problem.

The other problem with the way that the pension schemes work is that people can pay up to £40,000—either 100 per cent of earnings or £40,000, whichever is higher—annually into a pension fund and get the tax relief. The figure has come down in recent years. Only a few years ago, it was £250,000—a single individual could save that as a lump sum over a year of savings and attract tax relief. It came down only because of the financial crisis, which meant that the Government needed to boost its tax income again. I cannot be sure of this, but the Lamborghini provision is one way of appeasing the people who have "suffered"—I put that word in inverted commas—from the removal of that amount of pensions input relief.

The Convener: If Scotland had control of pensions, what could we do that would be different from that?

Rachel Holmes: For me, it would be a really good opportunity to take a step back and look at where we are and at Scotland's specific requirements. We are in a different risk category in terms of life expectancy from the rest of the UK. We have one policy coming from London and we have to apply that policy across the board, even though we have different circumstances. It is a chance to look at issues of equality and fairness, as the politicians desire and the electorate who elect them desire. It is also a chance to look at how we structure things and how we apply tax reliefs and where we might want to encourage poorer people at least to have the opportunity to benefit from some of those tax reliefs. In my view, they are unfairly disadvantaged at the moment.

The Convener: I will let colleagues in in a minute or so.

You say in your paper:

"Comparing the UK state pension provision to the rest of the world, the Melbourne Mercer Global Pension Index scores the UK at a C+ (alongside Chile) while smaller nations such as Denmark, Netherlands, Australia, Sweden and Switzerland are ranked above with A or B ratings.

The Organisation for Economic Co-operation and Development indicate that under UK pension provision the average person might receive 32.6 per cent of their final salary from the state once they retire. This is the lowest proportion in Europe. The average equivalent figure for the total 34 countries measured was 40.6 per cent. Austria offers 76.6 per cent."

Given that Scotland spends a smaller share of tax take and gross domestic product on social protection, which includes pensions, than the UK as a whole, does that mean that Scotland is better able to afford the costs of state pensions?

Rachel Holmes: At the moment, I would argue yes. I would hope that, in time and with the right policies, we would be able to address the age differential in the life expectancy figures, which are horribly lower in Scotland than those in the rest of the UK. Given the agreed current figures, we would have to agree that, at the moment, the costs are more affordable.

I also argue that there are risks in staying with the current system. The United Kingdom is severely in debt as a nation, and Scotland can do very little about that. People talk about the risks of our taking ownership of pensions provision, but I argue that the UK also faces severe risks in future. Independent organisations have said the UK state pension provision is really nothing to write home about. As you mentioned, the OECD has placed the United Kingdom at just about the bottom of the league, just above Mexico—I have that report with me. It is not as though we have a fantastic benefit or provision at the moment. I am not sure how Scotland could do any worse if it were to manage its pensions provision.

The Convener: Thank you. I now open up the session to my colleagues.

Malcolm Chisholm (Edinburgh Northern and Leith) (Lab): You make some general criticisms of pensions. I am sure that people might agree with many of your points, but I am not sure about your assumption that things would inevitably be better under independence. You say that we would be better able to afford the cost of the state pension, but do you not think that the indicator that was used last week by most of our expert witnesses—pension expenditure per working-age adult—is a pretty valid indicator of the affordability of pensions?

Rachel Holmes: We could use that indicator. If there is a problem, as you say, the question is how we address it. At present, we have absolutely no power to address the problems that we face, whatever indicators we choose. If we choose to take that particular indicator and it shows that there is an issue, what can we do about it? At present, we can do very little, because the powers are reserved to Westminster, which rightly makes decisions for the majority—those who elect the members there and the majority of the people. The majority of the people are not us—I think that we have 8 per cent of the MPs in Westminster and less than 10 per cent of the population. I am not saying that Westminster is in any way deliberately punishing or penalising Scotland; I am saying that the arithmetic of the situation is not helpful to us, in that it does not allow us to do what we want or need to do.

Malcolm Chisholm: I do not really accept your assumption that our circumstances are fundamentally different. They are different in that,

unfortunately, on average people do not live so long here, which is obviously one of the key problems that we need to address.

To stick with my original point, do you accept that, even at present, pension expenditure per working-age adult is higher in Scotland than it is in the rest of the UK? Unless we have the high immigration scenario that you outline, that will be accentuated more in the years to come. I am not necessarily arguing against the high immigration scenario, although there are problems with it in a common travel area.

Rachel Holmes: I disagree with your point about high immigration. We need immigration, but it need not be high. As it is, we already have net immigration of 22,000 or 24,000—I cannot remember the exact figure. I am no expert on immigration numbers, but I do not think that we need a scary high figure—if people would find it scary, although you say that you do not, and I do not either. Immigration is an emotive topic, as we know from the way that some of the press report it. From what I have read, I do not think that immigration needs to be drastic to address the problems.

You say that indicators show that we are ill-equipped or unable to fund our pensions, but I would like to consider why that situation has arisen. One could argue that we are less well equipped than other European nations that are of similar size and have similar demographics, yet they seem to be managing quite well. I argue that that is a case for saying that something is not quite right about the current situation.

Malcolm Chisholm: I do not argue that. Some of those countries have higher levels of taxation, which is certainly not proposed in the Scottish Government's white paper. I am not saying that you need to be committed to the proposals in the white paper, but, notwithstanding certain variations such as keeping savings credit, is not one of the significant things in it the proposal for the fundamental structure of pensions—and, to a large extent, their regulation—which is very similar to what we have at the UK level?

09:45

Rachel Holmes: That is fair. I am a gradualist as regards any kind of change, and I often think that it is better to work with what we have. I have put that in my paper. Any changes that we would make as a Scottish Parliament with power and control over pensions policy would need to be adopted only after a great deal of consideration and thought. No one is saying that whoever is in power following a yes vote should make sweeping, drastic changes. Such things will happen incrementally and slowly—but they will happen

where they need to happen or where members of the Scottish Parliament, who have the decision-making powers, decide what is best.

Malcolm Chisholm: You rightly criticise the policy whereby

“wealthier people benefit most with tax relief at higher rate”.

Will that change? Is that part of the white paper’s proposals on pensions?

Rachel Holmes: I do not believe that it is at the moment, although I have not—

Malcolm Chisholm: You will know, I presume, that the Labour Party at a UK level is going to abolish tax relief at the higher rate. Presumably, that rather undercuts your argument that only through independence can we fundamentally change pension policy.

Rachel Holmes: I could argue that that satisfies my personal views on equity, equality and so on, but it has taken a long time. People can still invest £40,000 a year if they have it, and they can get tax relief on their pension investment. These are my personal views about equality, redistribution of wealth and so on. I personally applaud the Labour Party for that proposal, but we would depend on getting a Labour Government to do it.

Jean Urquhart (Highlands and Islands) (Ind): Thank you for your interesting paper.

I want to go back to the comparison with other countries that have much higher pension levels. Is that all to do with investments that are made by those countries, such that they have a pension pot that we do not have? Do the countries that pay higher pensions pay higher contributions as well? Is that tied up with things such as other benefits? We can never consider such things on their own.

Do people who do not have big pensions enjoy advantages in this country in other ways, such as in relation to medical care?

Rachel Holmes: There is a big picture there. We have been talking about state pension provision and comparators, and some of the comparisons across different nations are based on proportions of average salaries and so on. Other variables have been stripped out. You are right: it is a complicated picture and is not an exact science.

My understanding is that the UK is one of the better countries in terms of private pension provision. I think that that is a good thing. Hence, I disagree with the Lamborghini reform that has just come in. If people have had the tax relief, they should be forced to take it as a pension—an annuity—so that they do not spend it all now and dump themselves on the state in 20 years’ time.

Mr Chisholm mentioned higher tax rates, and some of the comparator countries, such as Norway, have higher tax rates. However, their average income is also proportionally higher. Per capita, those countries are wealthier than we are, without a shadow of a doubt, even with their higher tax rates. For me, the argument is not about the fact that they pay higher taxes. The argument is about what people are left with in terms of per capita GDP, or wealth per capita, if that is the chosen measure. A lot of those countries are better off than us.

As regards investment, I do not have my sovereign wealth fund paper on me, but I know that some of the most notable countries that have sovereign wealth funds do so even without oil wealth. However, every country that has oil wealth, apart from the UK and one other country—I am not sure whether it is Iran or Iraq—

The Convener: It is Iraq.

Rachel Holmes: It is Iraq—yes. Apart from Iraq, we are the only country that has not invested a penny of its oil money. People say that the oil is running out—and it will, although I cannot tell you when—but what are we going to do with what is left?

The money has been used to fund tax cuts at the UK level over the past 10, 20 or 30 years, and it will continue to be used in that way. There will be no oil fund if we carry on sending the oil wealth to Westminster.

If we are going to use oil and pollute the atmosphere, it is crucial that we invest the money for the future. Norway has the biggest fund in the world—the biggest single collection of assets—and it can move the market every time it trades in oil. It is astonishing what Norway has done. It has saved the money and it is generating income every year, in perpetuity, that it will use for pensions.

If I am right, the white paper says that at least part of Scotland’s oil wealth will be put aside not only to fund future pensions in part, but to stabilise revenues year on year and smooth them to cope with the volatility.

Sorry—that is not a full answer to what was quite a full question.

Jean Urquhart: I will move away from pensions. You have been studying the experiences of overseas Chinese students. Can you talk about that, the advantage to Scotland that those students bring and how we might make best use of our universities’ reputations in that sphere?

Rachel Holmes: That is the area of study for my doctoral research. I teach at the university, and a significant proportion of my classes contain students who have just come off the plane from

overseas. For me, there is an ethical argument about how we best educate those students so that they receive an experience that they can expect to be in line with that of other students, which involves coping with language and so on.

Those students are important for the UK and for Scotland as a source of educational income. As we know, universities have expanded, but Government funding has not quite expanded along with them, either in England or in Scotland, although our home students' fees are paid for in Scotland. Overseas students are an important income stream for our universities now.

Internationalisation is part of my university's new strategy, as it was previously, and it is probably on the agenda for most universities in Scotland and the UK. Universities are now becoming more dependent on that income stream.

The issue brings us back to immigration policy. We are having to impose on our students some very strict immigration requirements under tier 4, and the university is having to implement a lot of strict administrative requirements to allow those students to come and study with us.

We are reaching the point at which we are now having to compete with countries such as Australia, which have slightly relaxed their immigration requirements for students. We now have to fight to get those students in, and there is a threat that they will go instead to India and Australia. That is a threat to us, and our numbers for this year—although I cannot give the exact figures—are certainly not growing as much as they were a few years ago. It would be beneficial for Scottish education if the Scottish Parliament had power over immigration.

Jamie Hepburn (Cumbernauld and Kilsyth) (SNP): I turn to an issue that Malcolm Chisholm touched on when he highlighted the evidence from the Pensions Policy Institute. He expressed a concern about the cost of pensions per adult of working age. However, the PPI's paper was predicated on the Office for National Statistics low population growth estimate, which I think was approximately 7,000 per annum. Rachel Holmes made the point that the figure is closer to 22,000 in reality.

The Pensions Policy Institute accepted that, if we use the higher estimate, which is closer to the actual levels, the cost for pensions per working-age adult would be better in Scotland than in the UK. Do you accept that point, Ms Holmes? I do not know whether you have seen the PPI's evidence, but will you accept the hypothesis? Does it come back to the point that you mentioned about having control over the levers that can influence those factors?

Rachel Holmes: Which paper did you refer to?

Jamie Hepburn: It is the evidence that the Pensions Policy Institute submitted to the committee last week.

Rachel Holmes: I think that we need control over that. I read Bell, Comerford and Eiser's paper yesterday, and one graph in it is telling. It is a graph of the net emigration to the rest of the UK and the net immigration from the rest of the UK into Scotland, and the lines cross at particular points. It seems to me that it is young people aged 18 to 39 who are leaving Scotland to go south. My brother is an example of that—he is in London with my nephew and we do not see them that often. What we need is for the young people to stay in Scotland. It is older people who tend to repatriate here, and for me that is part of the problem.

We need to have immigration from outside the UK and to attract young, talented people such as my brother-in-law, who is Polish and is a lawyer here, but we also need to keep the young people who grow up and are educated here. It would be good to keep them here, not only socially but so that they can put back what they have received from the country. They are an important asset.

Jamie Hepburn: I presume that it is a question of trying to provide here in Scotland the opportunities that they feel they have to go elsewhere to find.

Rachel Holmes: Absolutely.

Jamie Hepburn: Again, that would contribute positively on the issues of the cost of pensions and the working-age population.

Rachel Holmes: It would contribute to pensions because they would be here either creating wealth or paying taxes from public sector wages, but it would also be beneficial because the ratio of old to young would be rebalanced. It would address the criticism that we are somehow ageing more than the rest of the UK. I agree that we are ageing marginally more, but we are certainly not ageing as much as many countries in Europe. That was pointed out in the Bell paper that I read yesterday. Scotland might be worse than the UK in terms of ageing, depending on what indicator we take, but it is certainly not bad in comparison with the rest of Europe. If there is an issue with an ageing population in Scotland, we need to be able to do something about it.

Jamie Hepburn: In your submission, you state:

"Women have been treated poorly by the UK pension regime."

Why do you feel that that is the case?

Rachel Holmes: I have often thought that. It is not necessarily because I am a woman; it is because I have changed jobs more than is

traditional. It is normal now, but in my parents' generation it was usually the man who worked. More often than not, the woman stayed at home, went into part-time work or worked and took a career break to have children. In the past, it was much more likely that a man would start work and continue working, making all the national insurance contributions and then benefiting from the full state pension. For women, that was much less likely, from the state pension perspective.

From a private pension perspective, if people move jobs fairly frequently, as they tend to do now that there is more mobility and so on, they leave pension pots behind them. That is another big area. You might not want to open it up today, but I have been waiting for some provision whereby people can either consolidate such pension pots at low cost—they cannot do that at present; it is very costly—or somehow carry their pension with them. There is scope for some innovative, creative thinking on that, which to me has not happened, certainly in my working career.

With career breaks for children and so on, women have a more erratic pattern of NIC payments. To say that they are punished for that would possibly be to put it too strongly, but they are less likely to benefit from the full state pension on retirement, and the figures bear that out. There are more women than men in retirement poverty.

Jamie Hepburn: In your submission, you state that the Melbourne Mercer global pension index, which I freely confess is not an index that I was aware of before I read your paper,

“scores the UK at a C+ (alongside Chile) while smaller nations such as Denmark, Netherlands, Australia, Sweden and Switzerland are ranked above with A or B ratings.”

What does that mean in practical terms?

Rachel Holmes: It just means that the state pension provision by Government in the UK is much further down the list than anyone who does not pick up on these things and pay attention to them is aware of, in my view. There is debate in the news—in the press and so on—about pension crises, but no one has said that what we have is really quite far down the list on several of the rankings. The OECD one is the most recent one to have come out, to my knowledge.

Some people are saying that pensions will be at risk if people vote yes—I have seen a lot of that in campaigning. I saw a poster that said, “Put our pensions at risk? No thanks.” However, people's pensions are not that good at the moment, and who is to say that pensions are not at risk as things stand? The country is up to its neck in debt. The message that UK pensions are somehow safe, cosy and secure is a bit of a fallacy.

10:00

Jamie Hepburn: In a nutshell, Denmark, the Netherlands, Australia, Sweden and Switzerland pay pensioners a better pension than the UK does.

Rachel Holmes: Yes. On the whole, those countries are wealthier than us per capita. That applies in particular to Luxembourg, where I have experience of working. Being small is an advantage; it is not something to be scared of. A country can be small and wealthy. A lot of indicators show that most of the wealthy nations—in Europe, anyway—are small.

Jamie Hepburn: Does the same correlation exist in the OECD study?

Rachel Holmes: Yes. The OECD study is more international and does not cover just Europe. In its ranking, we come just above Mexico.

Jamie Hepburn: You say in your submission that we are ranked lowest in Europe.

Rachel Holmes: That is true. That is based on the OECD ranking.

Jamie Hepburn: Does the same correlation apply? Do the countries that are ahead of us tend to be more prosperous?

Rachel Holmes: That is true. Perhaps that goes back to Jean Urquhart's question about whether that is because some countries are emphasising pensions more and cutting health spending. That might be the case—I have not done an empirical analysis of the variables—but it stands to reason that, if a nation has more wealth per capita, which is the measure that I tend to use, surely it has more wealth to dispose of in state pensions.

Jamie Hepburn: Another way of describing that could be as having more wealth to share.

Rachel Holmes: Absolutely. My argument is not necessarily that the state pension should be increased immediately in an independent Scotland. We could do that, but that is for the committee, other parliamentarians and the electorate to decide. However, the position in an independent Scotland would certainly be no worse and we would have the powers to do something better or different that suits our risk profile, our age demographic and so on.

Gavin Brown (Lothian) (Con): Your submission says:

“Scotland could, in time, consider the attractiveness or otherwise of policies of other countries, for example offering tax relief on work and private pensions contributions based on age”.

Will you expand on that? Would younger or older people get more tax relief?

Rachel Holmes: I am not giving a view on that; that would be up to the Parliament to decide. I am saying that you could consider such topics and that we would not be stuck with what we have at the moment. You could look around. As I said, independence would be a chance to have a positive rethink—if that is wanted—and to consider other countries' policies. At the moment, you in the Parliament have no capacity to do that.

There is an opportunity. If age was used as a basis, older people could be given more tax relief as they approached retirement, to boost their fund, or tax relief could be used to encourage younger people to invest more earlier. You could use that in the way that you wanted. That is just an example of something that you might want to consider.

Gavin Brown: It is clear that you have considered the issue. Which option do you advocate?

Rachel Holmes: I have no view at the moment. I have not done a full and detailed study of the economic modelling. I see advantages in encouraging young people to invest. They tend not to save much, partly because they tend to have lower incomes and not to have as much disposable income. Having said that, I tell all my students to start saving now, because they will get the benefit of compound interest and the compounded growth of their fund if they start earlier. Such investment grows over a longer period and is much more powerful.

It could be argued that, as people approach retirement, they need to have more of their income freed up. More age-related relief could be allocated to them. That is a positive idea that you could consider, but you—the committee and the Parliament—cannot consider it just now.

Gavin Brown: You described the recent changes as the “Lamborghini” reforms. I do not know whether those were your words or you were quoting them from elsewhere. I got the impression that you were pretty negative about those reforms. At First Minister’s questions, I asked the First Minister which of them he would reverse and he did not suggest that he would reverse any of them. Would you reverse all of them?

Rachel Holmes: Which ones? Are you referring to every reform in the Finance Act 2013? Could you be more specific?

Gavin Brown: The one that you touched on most was the fact that it is not necessary to purchase an annuity. You were quoting someone else, but you implied that you thought that that was a little reckless. Would you reverse that policy?

Rachel Holmes: First of all, I did not use the word “reckless”. That was either the Pensions Policy Institute or the OECD head of pensions.

Would I reverse that policy? I would favour a Government that reversed it, but I do not have the power to make those decisions. It is a contentious policy and my feeling is that it has been introduced to appease the better-off, who have pension provision from other sources, can get their lump sums, do their world cruises and buy their Lamborghinis if they want. Given the crisis that we have all been talking about, I am not sure that it is a helpful reform.

Gavin Brown: If we were to become independent, you would not want that policy to be mirrored in Scotland. Is that correct?

Rachel Holmes: I could see it being equitable and sensible to remove the ability to cash your lump sum in now. That would disgruntle the better-off—that is okay—but it might be better for the country to have an annuitised income stream going forward so that people cannot simply spend all their pension now and leave themselves with nothing later on.

I am sure that there are many people who are sensible with their money. There are many wealthy individuals who are very sensible and will manage the situation without a problem. However, for me, there are two issues: first, there will inevitably be some people who do not manage it and, secondly, future elected Governments will not have that income stream.

Gavin Brown: Again, you are pretty critical about the decision from 1997 or 1998—I forget when it was—that you described as the pension “raid”. You said that it had not been revoked or reversed by any subsequent UK Government. If we were to become independent, would you call on Scotland to reverse that decision?

Rachel Holmes: I might. I might consider that to be helpful to pension savers, but it would have to be in the raft of policy decisions. We would need to have reviews of other aspects of pension provision. It would not simply be a case of taking certain things away. We have talked about a range of possibilities, and it could be part of the mix.

I am not a campaigner. I do not campaign to MSPs telling them what they should do with their pensions. I give a personal view—I guess that that is what you are asking me for—of what I would do if I was in power or what I would vote for.

I criticise the raid on pensions. It has been heavily criticised. “Raid” is not my word; it has been used vociferously by many other people. If you want to help people to have a better pension pot from their private pension, you could relieve them of that tax. It would be possible to tax them

or give them relief in other ways, as has happened. Parliament could decide to do that.

Gavin Brown: You also want there to be a redistribution between the richer and the poorer via tax relief on pensions. Is there any indication in the white paper or elsewhere that that is on the table?

Rachel Holmes: I do not think so, but perhaps you can correct me. I am not here as an advocate for the white paper. It seems quite generous to give tax relief at the higher rate to better-off people who can afford to put £40,000 into a pension fund annually. I consider myself to be well off. I have above-average earnings as a lecturer at Edinburgh Napier University, but there is absolutely nothing that I can do to put anywhere near that amount of money into a pension pot annually. I have to ask what constituency group has the money to be able to put £40,000 into their pension pot and why, if they are so wealthy, they are getting full relief on that at 40 per cent or more. It seems to me that it is overly beneficial for the better-off in society.

Gavin Brown: At the tail end of last year, the Scottish Government published a paper entitled "Pensions in an Independent Scotland", containing 109 pages. Is there anything in that paper that will make private pensions in Scotland better under independence than they are currently?

Rachel Holmes: My understanding from the white paper pensions provision is that we would inherit a system and that there would be a bit of negotiation and a fair amount of transition and sorting out what goes where. As I said, I do not see the need for a massive overhaul immediately, but what I do see is the benefit of the Scottish Parliament having the power to do things according to what you think is better for Scotland's pensions and what is better for the Scottish people. At the moment, you have no power over that; you are happy for that to rest in London. I am arguing that you should have the power to have a say on that and be able to do something differently. Your views on what you would do differently may differ from what your colleagues in London are doing just now, and it is not my job to ask you what they would be, but my question—and, of course, you do not have to answer me—is what you would do in Scotland if you had the power over that.

Gavin Brown: I am not a pensions expert giving evidence in front of the committee. I shall close with one question, because I think that what you are hinting at is that we would be better as an independent Scotland with pensions.

Rachel Holmes: That is not what I have said. I am saying that we could tailor our policies towards what we need. There is an opportunity to do

something different. You could do exactly what they are doing in Westminster if you want and if it makes sense to do so—I am not criticising everything that Westminster has done, because auto-enrolment is a great idea and we could do that as well. Just because we take power here does not mean that we have to stop doing what is good in the current system. The dichotomy in which thinking that powers should rest here somehow means that everything down there must be bad is wrong. What it gives you is the power to keep what is good but also to do some things differently as the need requires, whether that is to do with immigration and the age issue or keeping younger people in the country. That seems more beneficial than having to accept a one-size-fits-all policy coming out of Westminster.

Gavin Brown: I return to the paper. You say that we might be able to do things better or differently. Is there anything in the Scottish Government's published paper on pensions only, which was pretty comprehensive, that, in your view as a pensions expert, will make Scotland better for private pensions?

Rachel Holmes: There is, because we would be able to do things that suit the people of Scotland in terms of their private pensions. You can adjust tax rates, but only if you have the fiscal power to do so. My view, as I have said, is more in favour of egalitarian redistribution, but that might not be the will of the Scottish people. As it happens, though, you cannot do anything just now, so yes, I do think that there are things in the white paper that will help private pensions, because it will be this Parliament that addresses the issue, and you can choose what is best, presumably acting in the interests of the people who live here, not of 50 million people who happen to live elsewhere with a different economic, demographic and risk profile.

10:15

Gavin Brown: I am sorry to press you, but you said that there are things in the paper that would make a difference. What things?

Rachel Holmes: As a broad principle, if you have the power to change things, you can presumably do things for the better. The broad principle of the white paper is that the Scottish Parliament should have powers over these things. You must remember that the white paper presumes to set out what a Scottish National Party Government would do, but—who knows?—it might even be a Conservative Government; it could also be a coalition or a Labour Government. Such a Government would have the powers to do something.

The white paper presents the SNP's vision of what it would do were it to be elected. I would be delighted to hear what the pension provisions of the non-SNP parties would be should Scotland vote yes. I have asked that question previously, and I have not yet heard anything.

Gavin Brown: I am not talking about the white paper; I am talking about "Pensions in an Independent Scotland". As a pensions expert, do you think that there are specific proposals in that paper that will make pensions in Scotland superior to pensions in the rest of the UK?

Rachel Holmes: I cannot claim that there are specific items that would do that. Which paper are you talking about—the white paper or "Pensions in an Independent Scotland"?

Gavin Brown: I am talking about "Pensions in an Independent Scotland", which was published in September 2013 and is 109 pages long.

Rachel Holmes: There are such proposals in the sense that you will have the powers to do what you need to do.

Gavin Brown: As a pensions expert, you must be familiar with that paper. Are there any specifics in it—

Rachel Holmes: The words "pensions expert" are your words; I have never used those words. You can push me on that, but that is your description. I have come here on the basis of my personal knowledge, my work experience and the studies that I do in my work, but I ask you what you would do in the event of a yes vote if you could choose to do what you wanted.

The Convener: I do not think that we are getting anywhere.

Gavin Brown: I do not think that we are. I will close simply by saying—

Rachel Holmes: I would rather not go into the detail of that paper now, because I have not read it for a while.

Gavin Brown: Okay. We will leave it there.

John Mason (Glasgow Shettleston) (SNP): In your paper, you refer to the fact that the OECD indicates that

"under UK pension provision the average person might receive 32.6 per cent of their final salary from the state once they retire",

whereas in Austria the figure is 76.6 per cent. Is there a right answer? Is there an agreed level that we should all be aiming at, such as 50 per cent or two thirds, or is there not?

Rachel Holmes: I do not think that there is. Each country is unique and has its own electorate, who will have certain things that they are happy to

vote for and certain things that they are not prepared to vote for. To be honest, I have never thought about having a magic figure, whereby a certain percentage of a person's salary should be their pension. I know that, in this country, many people would find it very hard to live off the state pension, if that was their only provision, although there are many people who do so.

John Mason: I presume that 32.6 per cent is okay for someone who is a millionaire—they will be able to live on that—but for someone who has been on the minimum wage, even 76.6 per cent would not be enough to live on. Am I right to say that the level would vary?

Rachel Holmes: Yes. I guess that you would have to look at the figures on the living wage, on which an argument is taking place. The minimum wage is no longer cutting it—that is why we are seeing food banks and so on. I am not in a position to put a figure on a magic percentage of income that people should retire on. Some people will want or need more, but others will not.

We should have a two-pronged approach. Those who can save should be saving and the state pension should be there as a fallback or a catch-all for everyone. The figures that we have been looking at from the Mercer index and the OECD are to do with state pension provision. My only point is that we should not be thinking, "We're Great Britain—we have a fantastic pension." We just do not. There are reasons for that. From the figures that we have read and the report from Bell, I do not see why Scotland would be in a dramatically different position. It is true that there are slight differences in the age profile. We have talked about some of the indicators to do with taxes paid and so on, but I do not see why we cannot have such provision when other countries can.

John Mason: That was the kind of area that I was interested in—what is wrong with the present system. If we stayed in the UK, we could try to make the UK system better, albeit that we do not have a huge amount of influence.

We have talked about how richer people seem to get quite a lot of benefits by way of tax. What can we do about the bottom end? You mentioned the living wage and the minimum wage. Someone who is on the minimum wage cannot really save and the living wage, as I understand it, is what someone needs to live on, so I presume that we are also saying that someone who is on the living wage cannot save. Do we need to increase the minimum wage and the living wage so that everyone can save?

Rachel Holmes: I have not thought about that question before. I mentioned young people earlier. When I started out at Ernst & Young in 1990, my

salary was £9,250, which I thought was quite good. However, I did not save and I did not have much left over after all the bills were paid.

I am now on a university lecturer salary, which is well above average. I would be surprised if people who are on well above the minimum wage and the living wage could save very much. There might be a good argument to raise the minimum wage—morally, it might be the right thing to do—but I am not sure whether it would have much impact on pension savings. However, I base that on supposition; I have not done any empirical studies of that.

John Mason: I presume that the other thing to accept is that not everybody will have a funded pension at some stage. At the moment, we have a mix—I think that you have argued that in other countries more of people's pension provision is funded—but it seems that we will never get to the stage at which 100 per cent of people have a funded pension. Should we be relaxed about how much is funded or not funded and just accept that it is the duty of quite a large chunk of the population to pay for today's pensioners?

Rachel Holmes: To clarify, when we look across Europe, the UK has a bigger percentage of people with funded pensions—private pensions—and the state pension is falling down. As a slight aside, that makes people think that if they have a funded pension they will inevitably be better off. That leads them to ask what their responsibilities are to retired people who have not had the wealth to invest in a private pension fund and who do not get tax relief at 40 or 50 per cent on 40 grand a year, or whatever the changing rates are.

We are back to equality and the views of the electorate on equality and the distribution of wealth. I have never described myself as socialist—many people know that—but I believe that we have a moral obligation to the poor, the weak and the vulnerable. That is my personal view, so I agree with funding state pensions at a sensible level and I will continue to agree with that.

John Mason: You mentioned the admin costs of personal pensions. My father worked for one employer all his life, so I presume that the admin costs of his pension were fairly straightforward. However, a lot of us—me and people younger than me—have various pension pots around the place. Do admin costs tend to eat into these things?

Rachel Holmes: Are you talking about private pensions?

John Mason: Yes. I have three or four.

Rachel Holmes: I have three or four pots too, because I have worked in industry. I worked for one employer for eight years; I worked in

Luxembourg; and I have worked for major financial institutions in Scotland.

From personal experience, I know that I do not like having different pots. I would rather consolidate them, which seems to make a bit more sense economically. However, the charges are severe when money is moved and not much has been done to address that. That means that people take small amounts of stream from different pots, for each of which there are management charges, trustee charges and custody charges. That can be very expensive, as we know from the discussion around pension fund charges that has been taking place over the past few years. That is not helpful. I would love to see a provision whereby people could consolidate their pots without being hammered for it through charges.

John Mason: It has been suggested that the Dutch have a model in which they can pool a bit more, instead of just having individual pots. Are you aware of that?

Rachel Holmes: I am not an expert on that, but I would be interested in that being considered for the future of private pensions. That would be very helpful for an awful lot of people.

Michael McMahon (Uddingston and Bellshill (Lab): At the Welfare Reform Committee yesterday, the chair of the expert group that was set up to consider welfare change said that it was not possible to transplant different systems to Scotland from other countries, that Scotland would have to develop its own system and that huge transition periods and costs would be involved. Obviously, there would be some benefits in that as well, but he said that it was not appropriate to transplant systems from one country to another.

Scotland already has a particular system. We have a different culture. We are not the same as other countries. We are not starting from a blank sheet; we are starting from where we are. Where we are at the moment, people can analyse, assess and find fault with the system, or they can improve it.

Considering the private companies that are involved in that market, especially pensions, Standard Life has £240 billion of assets under management. In considering the potential for an independent Scotland, it has put in place a contingency to put parts of its operations outside of Scotland, because of the uncertainty. We might look towards an independent Scotland and say that we could do this or that, and it might be possible if we were starting from a blank sheet, but we are not. If there was change, there would be an impact from that change. Standard Life moving its assets to headquarters in the rest of the UK would have an impact on GDP.

My question is this: starting from where we are now, do you see the risks involved affecting the current pensions arrangements? What are those risks?

Rachel Holmes: You mentioned the Welfare Reform Committee. I thought that your question was perhaps to do with welfare.

Michael McMahon: No, I am speaking in general terms. That committee was discussing demographic changes, which affect pensions, too. Welfare provision is impacted by people's income, whether that is in retirement, at working age or whenever. All those things must be taken into consideration. I was just quoting the chair of the expert group on welfare and constitutional reform—an expert—who was examining the welfare implications for an independent Scotland. He said that it is not possible to look elsewhere for a model and then transplant it into Scotland, because we are not starting from scratch.

Rachel Holmes: I do not believe that we are starting from scratch either—I agree with you there. I believe that we are inheriting a situation that is as it is, as you have said. We must take that and work with it. We can keep what we want—we can keep all of it if we want—but change what we want to change as well, as a normal Government tends to do. I agree with you that we are not ripping things up; it is not like a ground zero or starting from a completely blank sheet. We have the possibility to change things in a way that suits the people who live in this country.

You referred to Standard Life. I seem to remember the same thing being said and done by Scottish Widows in 1997, before devolution. Mike Ross, I believe, wrote a very large two-page spread in *The Scotsman*, to which I responded. He said that devolution would be damaging to his business and that jobs would go. Not one job went. I worked for that company for several years, from devolution, and it has gone from strength—

Michael McMahon: But devolution is not independence. We kept the same structures—we kept everything in place and we changed some powers. You are talking about independence: starting a new country with a new system, separate from what we currently have.

10:30

Rachel Holmes: Why would we have believed Scottish Widows when it said that about a small change like devolution? Why should we believe what is being said now? That is the first thing.

The second thing is my experience of business. I have never worked for Standard Life, but I have worked for similar companies: Lloyds TSB, Scottish Widows, State Street Bank and Trust

Company, JP Morgan and Chase Manhattan, as it was before. If there is a yes vote on 18 September, there is no way that Standard Life will have the packing crates ready to move out. First of all, where is it going to have its building to accommodate the 3,000-odd people it employs there?

Michael McMahon: It does not have to. It is moving its headquarters; it just needs an office.

The Convener: Hold on a minute. Let the witness answer and then you can come back.

Michael McMahon: She asked me a question.

John Mason: It was rhetorical.

Michael McMahon: I missed that aspect of it.

Rachel Holmes: You can answer in a minute.

Secondly, I know some of the fund managers at Standard Life. They have come up from England. Why are they here? They are here because they like the lifestyle. They like sauntering across the meadows on their way to work. They do not want to go to Basingstoke now with their families, because they have kids at school here.

Where will Standard Life get all the expertise that it has built up if it is going to up sticks? Why would it? What advantage would there be? What is it running away from or escaping?

I want to put this in context. If you look at the notes in the accounts, which you have picked up on, where Standard Life made its big thing, you can see that it is just a few lines. It was just saying that of course it would serve the interests of the shareholders no matter what happens, under whatever Government. It costs about £100 to set up a new company—a shell company. I could set up a company in London now, registered in England, and it would cost me £100. It is not a significant investment for Standard Life to say, "We have set up companies in England." You can set up a legal entity for a few quid.

Michael McMahon: That is right.

Rachel Holmes: So I am not actually sure why everyone is saying, "Oh, they've started moving," because they have not.

As with Scottish Widows, I do not believe that Standard Life will move, because there is no reason for it to move. If you look at the board and the person who made those comments, their affiliations and who they have advised—David Cameron—you will find that we are not exactly talking about someone who is utterly impartial.

Michael McMahon: Has your current business looked at moving?

Rachel Holmes: I do not have a current business. I work for a university.

Michael McMahon: Since you are a member of Business for Scotland I assumed that you had a business.

Rachel Holmes: No. I have worked for businesses.

Michael McMahon: So you are in academics for independence.

Rachel Holmes: I am in both.

Michael McMahon: So you advise people in terms of promoting independence, but it is questionable for Standard Life or someone at Standard Life to advise the Prime Minister.

Rachel Holmes: If you are questioning my credentials because I work for a university now, that is fine.

Michael McMahon: I am not questioning your credentials. You are the one who said that we should look at the credentials of the person at Standard Life and at who they have advised.

Rachel Holmes: I am not saying that I am impartial; I am just giving you my views and using my experience in business over 20 years. You can accept that if you want. It is entirely up to you.

Michael McMahon: Okay.

The Convener: Thank you. That brings our questions to a conclusion. Thank you very much for giving evidence to the Finance Committee this morning. I suspend the meeting for five minutes to give members a natural break and a chance to stretch their legs.

10:33

Meeting suspended.

10:39

On resuming—

The Convener: We will now continue our consideration of Scotland's public finances post-2014 by taking evidence from Professor David Heald and Professor Alan Trench. I welcome you both to the committee.

Again, members have copies of the written evidence that our witnesses have provided, so we will go straight to questions. As usually happens in the Finance Committee, I will start with some questions and then we will move on to members of the committee asking their questions.

This time, rather than jump about from paper to paper as I usually do, I will begin by putting some questions to Professor Heald, but Professor Trench may comment as well, so we can have a wee bit of interaction. Our approach has worked pretty well up to now. We had one session that

lasted three and a half hours, but we will try to ensure that that does not happen today. You will be glad to hear that.

Professor Heald, in paragraph 2 of your submission you state:

“Expectations have been aroused inside Scotland for a ‘better devolution deal’, while – temporarily in my view – the voices outside Scotland that denounce its ‘excessive privileges’ are relatively subdued.”

Do you believe that that is a temporary phenomenon that will re-emerge after September?

Professor David Heald (University of Aberdeen): One thing that has surprised me since devolution is that, although the criticism of Scotland's position has always been there, it has never really reached a peak. People focus on the identifiable expenditure figures that are published annually by the Treasury and they also blame the Barnett formula for the position of the north of England within England, whereas it is completely irrelevant to that. It has gone pretty quiet at the moment, but I think you will find after the referendum that, if the answer is no, it will re-emerge.

There is a code language, which we see in some of the evidence that has been submitted to the committee. When people talk about reform of the Barnett formula, it usually means that Scotland should get less public spending. That relates to one thing that I was very critical of during the previous Labour Government. When there was plenty of money around and vast quantities of money were coming down the Barnett pipeline, I made proposals with Alasdair McLeod about how the Barnett formula could be altered in a way that would satisfy Wales and Northern Ireland, but that was not done. Basically, the Labour Government froze all debate about the future of Barnett.

If the answer in the referendum is no, we will be at a critical juncture. The Holtham commission was relatively mild in its language, but there is a paper by Gerald Holtham and another member, David Miles, in the *Financial Times*, that suggests that Scotland should lose £4 billion. I would expect a lot more articles such as that in the future.

The Convener: Okay. Professor Trench, do you want to comment?

Professor Alan Trench: There is a large set of questions. There is the question of how the Barnett formula works, on which David Heald is probably the greatest expert; there is the question of the political pressures that exist in England and in other parts of the United Kingdom, particularly Wales, for reform of the Barnett formula; and there is the question of what is likely to happen post-referendum.

I will take the last question first because it is probably the most pertinent. There is certainly a concern outwith Scotland about the level of funding that Scotland gets, and to be frank it is quite hard to justify that if the criteria are based on things such as relative need. That said, I see—somewhat regrettably—no sign that anything dramatic is likely to happen. We have explicit commitments from both Labour and the Liberal Democrats, whose papers that set out options for further devolution state that there should not be any change to the Barnett formula. The Conservatives took a similar position in the press conference, although not in the Strathclyde commission report.

There have been repeated assurances by the Prime Minister and various other UK ministers including the chancellor that there will be no change until the public finances are stabilised, which would appear to be some way off. On that basis, there may be an issue at some point when the public finances can be deemed to have been stabilised. However, there is no clear indication of any likely change, despite the significant political concern that I mentioned about the present arrangements in parts of England and particularly in Wales.

10:45

The Convener: Ruth Davidson said on 12 March 2012:

“I do think that there will be a review of Barnett after 2014.”

Alistair Carmichael said on 27 November last year that the Barnett formula’s future would depend on the outcome of the 2015 general election. That moves away from the referendum, but there are certainly murmurings, are there not?

Professor Trench: There are many murmurings. I advised a House of Lords select committee that reported in 2009 and recommended a different approach to funding through the block grant—in essence, a needs-based approach. There is a large number of murmurings, but there is no sign that it is anyone’s official policy.

The Convener: I understood that it was Lib Dem policy into the previous election.

Professor Trench: Well, it seems that it is not any more, if you look at the Campbell commission report.

The Convener: I am sure that that will be explored further as we go on.

Professor Heald, in paragraph 6 of your submission you say:

“the Treasury has unchallenged power”.

Then, in paragraph 7, you say:

“There is a transparency deficit that is undesirable now and—unless removed—would make major devolved taxes unworkable.”

Will you explain that to us?

Professor Heald: The reason why there has been less controversy about the Barnett formula since devolution is that, in the early 2000s, there were vast amounts of money coming through it. In my view, there was too much money, because the devolved Administrations could not absorb the amount of consequential that came from health and education spending in England.

Because there was plenty of cash, people did not pay much attention to the Treasury control of it. The Treasury has broadly followed the rules in the statement of funding policies that is issued at the time of most spending reviews. However, the point is that what actually happens in the operation of the Barnett formula is not put into the public domain. The data that I give you in my submission is a result of a series of freedom of information requests to the Scottish Government about tracking the evolution of the Barnett formula. You will see from the table in my submission that the formula is only part of the picture.

The Barnett formula is deeply embedded in the UK public expenditure system, which the Treasury controls. The reason for the quotation that you gave is that, until 2010, there was lots of money around and less focus but, if the Scottish finance secretary has to stand up and propose a Scottish income tax higher than the 10p that is the Calman deduction, there must be absolute clarity that the Treasury cannot make offsetting changes.

During the 2000s, there would have been a logic to Scotland using the tartan tax in a negative direction because the Barnett money was unabsorbable and built up in end-year flexibility, but all the political advice that ministers received was not to do that because the system was not transparent and the Treasury had plenty of levers to punish Scotland for using the tartan tax in a negative direction.

If the tax powers become more significant—they are significant at least to the extent that the Scottish Parliament will have to have a tax resolution—it is fundamental that all the numbers concerning the operation of the Barnett formula be put in the public domain immediately and that it not be necessary for academics to dig them out through freedom of information requests.

The Convener: You say in paragraph 10 of your submission:

“A pre-condition of the exercise of significant tax powers is that there is full transparency about the funding system. Otherwise, the tax powers will become unusable, subjected to mockery, vulnerable to gaming by the UK Government,

and to disintegration of the administrative infrastructure for assessment and collection.”

You go on in the following paragraph to say:

“Raising ‘own revenues’ cannot legitimately mean receiving the revenues generated in a sub-national jurisdiction through the application of a centrally-set tax rate to a centrally-prescribed tax base. This creates no political accountability: they are ‘assigned revenues’, even if not labelled as such.”

Professor Heald: Yes, as I made clear in the first paragraph of my submission, I have a long record of being in favour of devolved taxes and I still am. However, the point that I keep making is that the devolved tax must be usable. I do not see any point in having devolved taxes—I do not even admit their description as devolved taxes—if the system within which they operate makes them unusable.

For example, in the context of Calman, the Scottish finance minister has to notify Her Majesty’s Revenue and Customs by 30 November of the previous year of what the Calman tax rate will be. That is not publishing it, but I cannot believe that it can remain secret.

Given that the UK budget is not announced until the end of March or the beginning of April, how much money you get from the tax and the consequences for households depend on UK decisions in the March/April budget, meaning that the tax power will become difficult to use.

At the end of my written submission, I make the point that if fiscal devolution is to work—initially for Scotland, but possibly also for Northern Ireland and Wales later—it will require big changes at the UK level. There is a paradox: if the result of the referendum is no and there is more extensive devolution, particularly fiscal devolution, Westminster and Whitehall will, ironically, have to change more.

The Convener: Is there any sign that that is likely to happen?

Professor Heald: I spent 21 years as a specialist adviser to the Treasury Committee of the House of Commons, and the whole experience left me pretty depressed about Westminster and Whitehall. There is a fundamental problem in the UK. Although I believe that we need strong finance ministries, the Treasury and the Chancellor of the Exchequer dominate UK fiscal affairs and Westminster is pretty marginal.

Westminster and the UK Government must recognise that, to have fiscal devolution in significant income tax powers—whether that be under Calman, the whole of income tax or some compromise—there must be some basis on which the Scottish Government, the Welsh Government and the Northern Ireland Executive can plan their use of the tax powers without concern that

subsequent changes to the tax system at the UK level will compromise the operation of those powers.

It astonishes me that, over a very short period, we have moved from a situation in which about 1 million people paid the higher rate of income tax to a situation in which about 4 million people pay the higher rate. Because of fiscal drag, the higher-rate threshold now kicks in at a level of income that I do not regard as being particularly high. The decisions that are made about the threshold at which people start to pay income tax and the threshold at which they start to pay the higher rate are fundamental to the operation of anything other than a completely devolved income tax.

I do not know whether Westminster and Whitehall can reform themselves, but this is a critical juncture at which the issue is going to surface much more in political debate.

The Convener: It is not about whether they can, but about whether there is a willingness to do so. Professor Trench, do you think that such change is possible or likely?

Professor Trench: I know, from my academic work and my work as an adviser, that there has been a pretty broad reluctance within Whitehall, particularly, to embrace the sort of changes that are necessary concomitants of devolution. That said, the referendum debates have triggered much wider thinking and reflection on the matter than there has been before, and the commitment of the Conservative, Lib Dem and Labour parties to enhance devolution further will have quite a significant effect.

It is very clear that Whitehall’s willingness to change depends, first and foremost, not on bureaucratic inertia but on political will. We saw that dramatically in the debates around what became the Scotland Act 2012. Fairly attenuated proposals that had come from Labour in 2009 turned into much more far-reaching ones under the coalition in 2010 because of the lines that were taken by ministers in the incoming Government. That process is likely to be replicated, assuming a no vote in September.

If I might, I would like to say a couple of other things to pick up on what Professor Heald was saying.

The Convener: Of course.

Professor Trench: I largely agree with what Professor Heald said, particularly about the nature of the block grant process and budget constraints and how that will work with devolved tax powers. There are some big questions about that and some issues about transparency and data. However, Professor Heald is more sanguine than I

would be about how the Treasury has complied with the Barnett formula rules.

It is much easier to comply with the rules when you get a chance periodically to rewrite them, and that is an opportunity that the Treasury has had and has used. The most dramatic example of that relates to the 2012 London Olympics and the consequentials that should have flowed from that, which was a decision made around the spending review in 2007. There are blog posts on my blog, "Devolution Matters", that tackle that issue in great detail, and I would be happy to send them to the clerks if that would be helpful.

We have seen rewritings of classifications of public transport, largely in south-east England, and schemes such as Transport for London's crossrail that have had the effect of increasing the consequentials that were available to Scotland—rather than reducing them, which was the case with the 2012 Olympics. Those decisions are taken in a rather hasty and non-transparent manner at spending reviews when the statement of funding policy document—one might call it the operations manual to the Barnett formula—is written. The process badly needs review and has done for quite a long time.

Professor Heald: A point that I forgot to make is one on which I would disagree with my co-witness. Broadly, the formula has been followed, but I draw the committee's attention to the £607 million deduction from the previous year's spend to get into the spending review 2013 baseline, which is shown in table 1 of my submission. To the best of my knowledge, there is absolutely no provision for some Barnett consequentials to be regarded as temporary, and hence reversible. The Olympics and the Carter review of prisons are mentioned in a footnote, so the difference between me and my co-witness is really about how to categorise such things.

Given what has been happening elsewhere in UK public finances over that period, I still stick to my judgment that the rules are broadly being followed. However, I am concerned about suddenly getting a new classification of Barnett consequentials as temporary or one-off. I had never heard the distinction between permanent and temporary in the context of Barnett consequentials—that was new to me when I got the numbers for what actually happened at spending review 2013. That is a good example of why we need more transparency at the time, not transparency when we actually get the numbers much later. When the decisions are taken, the Westminster Parliament and the Scottish Parliament should have the numbers to see what has actually happened.

The Convener: Professor Heald, in paragraph 9(b) of your submission you state:

"The expenditure-based financing system, with broad expenditure-switching powers, is congruent with the reality of the UK public expenditure system; the 16% of the population living in the Devolved Administrations were sufficiently marginal to UK political debates for some spending legacies and policy deviancy to be tolerated at Westminster and Whitehall".

Can you expand on what you mean by that?

Professor Heald: One of the points that I make in my submission is about how some people call Barnett a needs formula. It is not a needs formula; it is an adjustment formula. However, contrary to some of the other evidence that you have received, there is a respectable rationale for the Barnett formula. The Scottish ministers' freedom to spend and how they spend, and the Parliament's own powers, crucially depend on the block grant nature of the spending system. If you had a system that was built up from a disaggregated needs assessment, you would run the serious risk of getting more earmarking and ring fencing of particular kinds of expenditure.

The block grant nature and the fact that Westminster and Whitehall cannot intervene in the composition of Scottish spending have allowed Scotland to follow its own policies. An obvious example is the policy on higher education tuition fees. That is not liked—to put it mildly—at Westminster and Whitehall, but because it happens within a block system the Treasury cannot intervene.

11:00

Another point is that the Treasury quite likes Barnett, in a certain sense, as I explained in my submission. What Barnett means for the Treasury is that it does not have to get involved in the detail of Scottish programmes. Before Barnett and before devolution, Secretaries of State for Scotland were quite skilful at getting what they described as Scotland's share and then running separate arguments about the various reasons why Scotland needed more.

From a Treasury point of view, Barnett means that it can concentrate on the big English programmes in health, transport, law and order and justice, work out the spending for those departments, put that into the Barnett calculations and get a number for the three devolved Administrations. In that way, the Treasury avoids a lot of face-to-face negotiation about devolved policies in three jurisdictions about which it does not know very much, which would put it at a disadvantage. Therefore, another reason why Barnett has survived is simply because it has practical advantages for the UK Treasury.

Professor Trench: I agree that an attraction of Barnett is its practical advantages to the Treasury as well as to devolved finance ministers—

including those who do not do as well from the formula as the Scottish finance minister does—because it gives a stable and predictable revenue stream.

I also agree with Professor Heald's comment about disaggregated needs assessments. If we were to go down the route of something like the 1979 needs assessment, which was highly detailed, not only would that be a very time-consuming exercise but, because it involves making a detailed assessment of needs in relation to roads and transport, health and other fields, it would be very likely to lead to de facto ring fencing.

A merit of the sort of approach that Gerald Holtham outlined in the report of the Independent Commission on Funding and Finance for Wales is that it gets away from that. It uses a small number of high-level indicators, which cut across service fields, so it produces a block of money, of which it is hard for an individual devolved minister to say, "This is my share; I require it." The approach enables a wider cross-Government decision to be made.

That said, one problem with the Barnett formula arrangement—I know that Professor Heald disagrees with me on this point—is that there is a de facto, implicit link between public policy in England and public policy for the devolved Administrations. That is less acute a problem for Scotland, because of the relative generosity of the formula, which means that there is quite a bit of room for manoeuvre. The problem is much more striking for Wales, although it applies here too. Changes in the block grant can be reductions as well as increases, of course, and changes that are made in England will follow through.

For example, the block grant for all three devolved Administrations was reduced when the UK Government decided to abolish the teaching grants for universities, for the humanities and social science subjects. A large chunk of the existing teaching grant for what are now considered to be non-priority subjects went, and that fed through to a reduction in the block grant for all three devolved Governments. That increased the strain that is being felt as a result of pursuing different higher education policies.

That is likely to be the case in future. One must point out that the effects of austerity have not been hugely felt so far in spending terms, first, because they have been overwhelmingly borne by the local government budget in England and therefore by consequential shares of that for Scotland and Wales, which are limited because of local taxation; and secondly, most particularly, because the two largest devolved spending areas—health and schools—have been ring fenced in England. If that ceases to be the case after the next UK election,

there are likely to be consequences for devolved budgets.

The Convener: Professor Heald, in paragraph 13(e) of your submission, you say:

"The relationship between the devolved taxation system and social security is critical, both in terms of system functioning and political credibility."

Will you expand on that?

Professor Heald: One of the questions that you have to ask yourself about income tax—which I think is the right major tax in a devolved system—is how far you can go with devolved control over rates before you start worrying about the interaction with the benefit system. On the whole, people thought that the tartan tax power was not too large. The Calman tax power is superficially a bigger power than the tartan tax power, although in practical terms it might not be, because political constraints probably put quite a narrow band on changes to it.

If, for example, you devolve the whole of income tax, you then have the question of the relationship between national insurance contributions and income tax. You also have the question of the relationship between the social welfare benefit system and the tax system. Some of the things that have happened in the past four or five years have led to some bizarre marginal rates of personal income tax at UK level, for example in the context of the withdrawal of child benefit, the removal of the personal allowance over £100,000 and pension contributions. You have certain spikes on the income distribution. You also have the question of the relationship between tax thresholds and rates and universal credit.

The most visible sign, politically, of those issues is the so-called bedroom tax. For example, if the Scottish Parliament takes over the whole of income tax, you will have got into an area where you cannot neglect the interaction between the income tax rates and the benefit system. Otherwise, you will get lots of publicity about bizarre marginal rate structures where people lose a huge proportion of additional income.

If you have a devolved income tax power—this goes back to my earlier point that it is the UK that has to change—but national insurance contributions are a UK decision, you could have a situation in which the UK Government cuts income tax at the UK level but puts up national insurance contributions. Unless there is a functioning concordat between the UK Government and the devolved Government, you can imagine the difficulties that you will get into.

Professor Trench: There is certainly scope for an interaction. I do not think that those problems are by any means insuperable. They come about in part because of the difficulties that there have

been in running a simplified tax system. We have a notoriously complicated tax system. It is perhaps not as bad as that in the United States, but it is nonetheless not particularly good. One of the things that informed the work on “Funding devo more: Fiscal options for strengthening the union” was the Mirrlees review, which was the very comprehensive attempt to assess what a simplified tax system looked like and which was carried out under the chairmanship of Sir James Mirrlees for the Institute for Fiscal Studies and published 18 months to two years ago. There are ways to resolve all those issues. As Professor Heald says, they would require you to ensure that you had some effective clarity of lines between the roles of the various functions and the roles of the respective Governments, but the issues are perfectly superable.

The Convener: Professor Trench, your paper starts by saying quite helpfully:

“I am chiefly concerned with the implications of a No vote”.

It is quite focused in that regard. On VAT, you say:

“retaining the receipts from the tax would give the Scottish Government both a direct interest in ensuring economic growth, and a way of reaping the fiscal rewards of doing so. That would help make a measure like universal childcare much more affordable and practicable.”

Will you talk a wee bit more about the potential for assigning VAT revenues?

Professor Trench: The work on “Funding devo more” started as an exercise to apply the lessons that could usefully be learned in the UK context and take into account good tax and administrative practice from the many other federal and decentralised systems around the world. I was profoundly unconvinced by people who said, “We can’t do that here—it’s too difficult,” as if the UK, its arrangements and people are somehow less able to deal with such things than the Canadians, Australians and Germans, for instance.

One of the big problems is that there are a limited number of taxes with which one can ensure that a significant degree of responsibility is in the hands of devolved Government, and several of them are not suited for devolution under any circumstances. There are significant difficulties with employers’ and employees’ national insurance contributions, for example. VAT is an attractive option because devolving some form of sales tax is a very common approach in federal systems—countries such as Canada and the United States routinely have sales taxes set at the level of sub-state Government—and the receipts of taxes such as VAT are commonly used to fund state-level Government in countries such as Germany and Australia.

European Union rules mean that it is necessary to have what the EU regards as a single VAT across the member state. The same rate of VAT has to prevail on a particular class of items. How items are classed is a matter for national discretion, but the same rate has to prevail across all the member state’s territory. An independent Scotland could happily set the rate on domestic fuel lower—or higher—than the 5 per cent that it presently is, if it so wished. Likewise, it could, for example, do something with the present zero rating of items such as books and children’s clothing or choose to reduce or increase the headline rate. Those decisions would all be open to an independent Scotland, but they are not open if we are trying to devise a decentralised tax structure within the continuing United Kingdom.

Nonetheless, it is attractive to consider assigning VAT revenues because it is a relatively stable tax in the short to medium term. By tax standards, VAT is not particularly volatile. Some taxes are volatile and some are not: income tax is not volatile and nor is VAT, but corporation tax is. That is one attraction.

VAT is also, over time, a growth tax, so it provides a secure, rather than less secure, basis for devolved funding, and it would be hard to imagine circumstances in which Scotland would not want to have a sales tax or VAT of some sort. Indeed, it would be a requirement for an independent Scotland if it were to be a member of the European Union in any event. VAT is a tax that a state has to have, and it has to have VAT at a certain level. VAT receipts are a useful source of income.

Assignment of taxes is generally regarded as an unattractive option to pursue, and there are some good reasons for that. In particular, it involves an asymmetric transfer of risk. It means that one bears the burdens of fluctuations in the revenues that the tax generates without being able to use the rates or incidence of the tax as levers for stimulating economic behaviour or mitigating the revenue risk. That risk is more acceptable in relation to VAT than in relation to any other tax principally because it is a relatively stable tax, and one of the advantages of assignment is that one is able to draw direct benefit from a successful economic policy.

If one is able to use the other levers of economic development to stimulate economic behaviour, that enables one to reap the benefit of that as well. Quite a number of those levers—not all, by any means—are in devolved hands, including vocational education and financial assistance to industry, which can involve a variety of options such as cash grants and site preparation. That strikes me as helping to make the asymmetry of the risk significantly lower and to

create an incentive to secure prosperity, which is to everyone's benefit.

11:15

Professor Heald: I am deeply suspicious of arguments about assignment, because they confuse the issue. I am not saying that assignment might not have some role within a system, but if we want to get the accountability benefits, we need to have taxes that people can change. With tax assignment, Scotland would basically get the amount of revenue that followed the UK Government's decisions on the tax base and the tax rate. I am dubious about the growth effects, particularly with reference to things such as VAT. Scotland would take the fiscal risks of revenues falling short, without having the policy levers. Assignment also confuses the debate, because you start getting arguments about what proportion of funds is, quote, "financed by the Scottish Parliament". If they are being financed by taxes over which the Scottish Parliament has no control, I see no accountability benefits.

The crucial point is that we need taxes that we can actually do something about. Otherwise, we will end up in the situation that Northern Ireland was in after the Government of Ireland Act 1920, where in principle Stormont had lots of powers but in practice it could not change its taxes. The danger with the Calman tax, a post-referendum all-of-income-tax approach or something in between is that we get a system where we have to pay the administrative costs and households and the private sector have the compliance costs, but we cannot use it.

I am not necessarily against assigning VAT if it is clearly part of a system in which there is constitutional protection of our right to vary the tax and, if appropriate, alter the tax base. However, to pretend that X per cent is generated in Scotland when in fact we have no policy control does not strike me as providing the benefits that people seem to think we will get from devolved taxes.

Professor Trench: I emphasise that the devo more proposals regarding VAT assignment are part of a wider package that includes devolution of income tax and a number of other taxes. They were designed to help to ensure a wider degree of genuine tax control and accountability, but also to move us beyond simply talking about accountability and to ensure that there is a sustainable financial system that is rooted in something rather more far reaching than that rather limited—in my view—criterion.

The Convener: I will ask just one more question because time is marching on and I want to let my colleagues in—they have been very patient.

Professor Trench, you mention "Funding devo more" in your submission. In paragraph 20, on the implementation of fiscal devolution, you state:

"It is worth noting that these proposals amount to a programme for further devolution that would take around 15 years to implement, at least."

Professor Trench: Yes.

The Convener: Will you say a little more about that?

Professor Trench: As I state in the next sentence, some steps can be delivered relatively quickly. In particular, the devolution of income tax is much more straightforward now than it would have been five years ago because the implementation of the Scotland Act 2012 deals with a number of the key issues that are involved. Perhaps even more important than the legislative changes is HMRC's work on things such as identifying Scottish taxpayers, which is making it address the issues of fiscal devolution in a more thoroughgoing and substantive way than it has done up to now. That is a necessary step if we are to move towards anything further.

Assignment of VAT receipts, if that is done, can be done relatively quickly. There are issues about working out exactly how much is attributable to Scotland, and work would need to be done on that. I suspect that it would necessarily be an iterative process; it would develop over time, in the same way that—

The Convener: Why would it take 15 years? That seems an inordinate time.

Professor Trench: Those steps would not take that long. They are relatively quick steps. They would probably take in the order of three to five years. However, other measures are likely to take rather longer.

For example, an option that is canvassed in "Funding devo more" but which has not been embraced up to now is the idea of devolving employers' national insurance contributions and the payroll taxes that are incurred for that. That would be appropriate only if a devolved Government was taking on a major social security role and would involve quite a major reconstruction of the national insurance system. The roots of the system go back to about 1910, and it has not been through any significant change since 1975—and even that was comparatively limited. That is a really big administrative thing to do, and it is the sort of change that is likely to take quite a long time.

Another, much more minor, option that I recommend is that capital gains tax in relation to land transactions be devolved. Again, a fairly significant change would be necessary in how CGT is assessed, charged and collected. You

would have to make a fairly significant change to the rules for CGT, so it would not be a straightforward step.

If one were to seek to implement such recommendations in full, one would get into a fairly lengthy and complicated process. We know—the Scotland Act 2012 shows us this—that fiscal devolution is not quickly accomplished.

Professor Heald: I stress that the Calman tax does not affect savings or dividend income. If the whole of income tax was going to be devolved, you would have to worry about the possibility of tax arbitrage between income tax and corporation tax. In the 2000s, there was an issue when the lower corporation tax rate encouraged a lot of new incorporations and gave rise to the possibility of arbitrage between income tax and corporation tax and between income tax and capital gains tax, which is usually taxed at a lower rate. There are complications around the relationship between a Scottish tax system and the rest-of-UK tax system that applies to Scotland, which require careful thought.

Nevertheless, I have great sympathy with the convener's point that, if you are going to do things, you must do them quickly. The critical juncture that I spoke of at the beginning of my evidence, which would arise after a no vote, would not last long and it would be important to get the Calman tax up and running while the legislation was being created to allow the settlement to go beyond that. It would be important to do things quickly within the window of opportunity that existed.

Jamie Hepburn: Professor Heald, you feel that there is an appetite out there for cutting Scotland's funding that could become a reality in the context of a no vote. Could the UK Government achieve that without officially or formally altering the Barnett formula? Could it use another means?

Professor Heald: If the numerical operations of the Barnett formula were public at the time when that was done, no, it could not do that without attracting attention.

My minimum requirement is far more transparency immediately about the operation of the Barnett formula. For 20 years, I have been trying to get the numbers in the public domain for the comparable English spending that drives changes in the Scottish spending. Those are not the same as the numbers for identifiable expenditure in the public expenditure statistical analyses white paper. For 20 years, the Treasury has pretended not to understand the question, but something must be done. You must know exactly what spending in England is driving Scottish spending.

If the Barnett formula is not transparent, there are things that can be done without attracting

attention. There is delightful coverage of what happened—in 1984, I think—when John Redwood, who is now an MP, was an adviser. Papers in the National Archives show how the Government tried to change it quietly, without anyone noticing.

If you have the tax powers and if the finance minister has to justify having a Calman tax rate of more or less than 10 per cent, you must have the guarantee that no offsetting adjustment will be made at the UK level. That is all about keeping Barnett.

On the other part of your question, probably the biggest disagreement between me and my co-witness is that I think that if there is a no vote there will be a big pressure post-referendum to review Barnett. When people talk about reviewing Barnett, they usually mean cutting Scotland's spending because they have already decided, before the needs assessment takes place, that Scotland currently gets too much—you need only look at the other evidence that was presented to the committee for today's meeting to recognise that. I think that that will be a very difficult context. I do not see the Scottish Government agreeing to a quick and dirty needs assessment, particularly one that is controlled by the Treasury.

The alternatives are the Australian type of very detailed system, which is actually very expensive and controversial but has been running for a very long time, or a few indicators that generate a number. However, once you start generating a number that is, for example, advantageous to Wales but disadvantageous to Scotland and Northern Ireland, the latter two will argue. You will find that what starts as a simple system actually becomes more and more complicated, particularly as the jurisdictions that are damaged by the formulas start arguing. You have only to look at the history of local government distribution in England to realise how political these things become.

Jamie Hepburn: The short answer to the question is that because the Barnett formula is a fairly opaque process—the Barnett formula itself is well known but how it operates is not—Scotland's funding could be cut.

Professor Heald: If it was not made transparent, it could be cut, but I would regard transparency as a fundamental. The Scottish Parliament should forget completely about the Calman tax powers or income tax powers if you do not get transparency about the grant.

Jamie Hepburn: I will come on to that, because you said in your submission:

"More devolved taxes will mean that the block grant is smaller but its role will remain critical ... The Scottish

Government would have to be ready for extremely tough financial negotiations.”

You just hinted a moment ago that the Scottish Government should not agree to a process that is not to its liking. We are grappling with that issue just now, albeit on a much smaller scale, with regard to the two smaller taxes that have been devolved.

The real issue here, of course—I suppose this comes back to the paradox that you talked about, in that the change in culture needs to be at the Westminster level—is surely that, under devolution, power is retained at the UK level. We can negotiate all we want, but at the end of the day Westminster can impose whatever system it chooses, can it not?

Professor Heald: Clearly, under a system of devolution, a lot of power stays at the UK level. I would make a distinction between what can be imposed secretly and what can be imposed in the public domain, which is an important difference. It is clear that even full fiscal devolution is not independence, because certain powers are retained at the UK level. However, I would argue that there are benefits for the UK, because there are important senses in which the UK has mismanaged its taxation system. I have already made the point about the drift of more people into the higher rate, which I regard as undesirable. Coming closer to home, Scotland has not had a council tax revaluation since 1991—that is also the case in England—which basically destroys the credibility of the council tax as a very important form of local taxation.

The thing that has been seen in both Scotland and England is that although we are all talking about the benefits for democratic accountability of having more tax powers, both the Scottish Government and the UK Government—the latter with respect to England—have basically been removing local authorities’ council tax discretion. That has been done through the legislative provisions around referenda in England or just through playing around with the grant system. There is very clearly an important cultural question for the UK Government, but there is also an important cultural question for Scotland.

Jamie Hepburn: Professor Heald referred to his position on the Barnett formula and Professor Trench said in his submission:

“No party has any commitment to change the Barnett formula after a No vote.”

I thought that that was interesting, because we know that the Strathclyde commission, which I understand Professor Trench advised, committed to

“the creation of a Committee of all the Parliaments and Assemblies of the UK”

to look at the

“representation and financing of the devolved bodies in a manner which is fair to all parts of the United Kingdom.”

I would have thought that that would involve reviewing the Barnett formula.

Your submission also cites the Campbell commission’s report, “Federalism: the best future for Scotland—The report of the Home Rule and Community Rule Commission of the Scottish Liberal Democrats”, which at paragraph 131 states:

“The Liberal Democrats have long believed that the Barnett Formula should be replaced”.

11:30

David Cameron has previously told *The Herald* that the Barnett formula “cannot last forever”. Earlier today, the convener cited Ruth Davidson, who has said that she thinks

“that there will be a review of Barnett after 2014.”

Alistair Carmichael, in an STV interview, stated:

“We”

—the Liberal Democrats—

“do want to see Barnett scrapped.”

Should we just ignore all those people and take at face value your assertion that no party wants to scrap the Barnett formula?

Professor Trench: You can decide whether you take at face value those various statements, which express varying views. The other—

Jamie Hepburn: As far as I can see, they are expressing only one view.

Professor Trench: You are quoting rather selectively. You are not including the many ministerial statements of the current UK Government position, which is that there will be no change in the Barnett formula until public finances stabilise. That has been stated so often that one loses count.

You also ignore the fact that the report of Scottish Labour’s devolution commission, entitled “Powers for a purpose—Strengthening Accountability and Empowering People”, says that there will be no change to the Barnett formula, and the fact that the Campbell commission said that there would be no change in the short term.

Can the Barnett formula last for ever? Anything can change, and there can be no guarantee writ in stone that the Barnett formula will last until the end of planet earth. That is simply impossible. The Barnett formula has proved to be a remarkably durable mechanism, and one suspects that at least some of its features would need to be replicated in any grant system to reflect the reality

of the United Kingdom and of how the UK Government works.

However, I simply see no appetite to make that sort of change. A significant part of my working life has been spent in dealing with Welsh issues; the pressures and the situation in Wales are obviously entirely different to those in Scotland. However, life would have been made an awful lot easier in a Welsh context if there were any sign of a willingness to make alterations in the Barnett formula. Those signs are simply not forthcoming, despite a lot of work and a lot of political pressure being exercised. The issue has never come to the table, even from the perspective of those who would dearly love to see it changed and are doing their utmost to secure that.

Jamie Hepburn: There is one quote that I forgot to select. Ed Balls said that the Barnett formula

“was never intended to be long term”

and

“needs to be looked at”.

He is the shadow chancellor—Labour’s prospective chancellor. Again, should we just ignore that view?

Your perspective is that, because those parties are saying one thing now in advance of a referendum on independence, they will not look at the Barnett formula, and we should just trust them.

Professor Trench: No; you are assuming that, when they look at the formula, it will necessarily be changed.

Jamie Hepburn: So they will look at it and come to the conclusion that it does not need to be changed.

Professor Trench: Conceivably they might. As I said, my view is that the Barnett formula is, for many administrative and constitutional reasons, inappropriate for the situation that now exists. I am really quite surprised to hear someone from the Scottish National Party speaking out in favour of the Barnett formula, which is in essence a mechanism that was devised to allocate funds to the Scottish Government, which is a Government with a very distinct political composition from the Government at Westminster. The roots of the formula lie in a mechanism to allocate funding within a single Government bound by collective responsibility at a time of remarkable austerity. That is where the Barnett formula starts.

Those circumstances are very different from the ones that exist now. If the SNP is going to start urging that devolution ought to be unpicked, that would certainly be a headline for our colleague from the press who is sitting behind me.

Jamie Hepburn: I am not advocating anything in particular. I advocate independence, Professor Trench—

Professor Trench: As I would expect.

Jamie Hepburn: I am looking at your evidence, and your position seems to be that there will be no review of the Barnett formula—which is, after all, what we are looking at today. We can invite Professor Heald to comment in a minute, as he seems to take a different perspective. There seems to be a lot of evidence out there that the Barnett formula is being looked at.

Professor Trench: I see little evidence that there will be any significant change.

Jamie Hepburn: But you would take a slightly different view, Professor Heald.

Professor Heald: I have no idea what would happen, but my fear is that there would be a significant challenge. As I said, when people talk about reviewing the Barnett formula, it is usually coded language for cutting Scotland’s expenditure. Generally, those who make that argument have formed their conclusion based on existing evidence that Scotland is overfunded.

When, 12 years ago, I suggested altering what the Barnett formula converges on in a way that would particularly help Wales, the Labour Government closed down all debate on the matter. I regard that as an example of fiscal mismanagement, along with council tax revaluation. We now have an enormous problem because no Government dares revalue the council tax base. Geographically, the changes would be really dramatic, particularly in England. If there had been more transparency about Barnett and if people had been willing to discuss it, a relatively small change could have been made to the formula that would have been beneficial to Wales.

Something else that was not done was to think about the English regions. Bizarrely, the Barnett formula is blamed for the economic conditions in the north-east of England. That area is now being hit; indeed, as the former director of finance at Newcastle City Council has made clear, what is happening in local government in the north-east is actually worse than what happened in the 1980s. Barnett gets the blame, but it has nothing to do with it. By managing the system, we could have avoided the potential crisis after the election.

As for whether we should trust what people say now, my answer would be no. I rather remember what people said about tuition fees in England before the last election.

Jamie Hepburn: Indeed. Unlike Professor Trench, then, you feel that when people talk about reviewing the Barnett formula, it is not because they are going to get up and say, “The equation is

perfect and shouldn't be changed." They just want to cut the amount of money coming to Scotland.

Professor Heald: If you read the rest of the text in which people propose a review or reform of the Barnett formula, you will find that a fair interpretation.

Moreover, the people who say that there is no logic in Barnett forget that this is an attempt to make asymmetric devolution work for 16 per cent of the UK population. The centralisation of the UK is much more intense than centralisation in other states of a similar size. You can criticise Barnett from first principles, but you also have to look at the functional role that it plays, and I have argued that its functional role has been to give this Parliament and Government autonomy about how to spend a fixed budget and to give stability with regard to that budget. The fact that the Scottish Parliament and Government have reasonable predictability about the future budget is actually a beneficial consequence of Barnett.

I think, therefore, that people are wrong when they say that there is no logic behind Barnett. There might have been a case for managing the system, changing the name or something, but it is just wrong to think that a needs assessment is simple and that the adjustment process will be easy once people find out that, as they had expected, Scotland and Northern Ireland are overfunded.

Jamie Hepburn: Finally, I note that in your submission, Professor Trench, you say:

"All three pro-UK parties are now committed to further forms of devolution in the event of a No vote."

Do you not accept that those proposals have come from the Scottish branches of those parties, and that the question of further devolution relies on the political parties at a UK level? I know that you have been somewhat critical of their handling of the devolution of further powers. You have mentioned your "Devolution Matters" blog, and I know that you were fairly critical of the UK Government's failure to take forward the Calman commission recommendation on the devolution of air passenger duty. Again, the Strathclyde commission, which you advised, called for the devolution of that tax power.

As it happens, David Gauke, a UK Treasury minister, gave evidence to the committee, and when we explored the issue with him, it became pretty clear that there would be no commitment to devolving APD from him or his Government. Given that his party's commission made that recommendation, you would have thought that there might have been. In fact, he said that the commission had merely made a welcome "contribution to the debate", which is hardly a ringing endorsement of his own party's position on

the commission. I know that you cannot answer for Mr Gauke, but if the UK Government is not likely to devolve APD, it does not seem realistic to assume that it will substantially devolve anything else.

Professor Trench: I do not agree. APD is a comparatively small and minor tax that is not in any sense a significant source of revenue; indeed, according to the latest "Government Expenditure and Revenue Scotland" report, which is for 2012-13, it represented 0.5 per cent of total non-North Sea tax revenues. Arguably, it is used as a policy lever, and its devolution was sought by the Calman commission and recommended by the Strathclyde commission on that basis. Given the overall concerns of trying to get a wider package of secure devolved funding, I would not worry a great deal about 0.5 per cent when much larger sources of revenue are being discussed.

Jamie Hepburn: But is that not the point? If the UK Government is not willing to devolve something so minimal, why should we take it on faith that it will devolve something substantial?

Professor Trench: Because the subject is legally intricate—I gather that it involves certain state aid issues—and there are also complicated airline and aircraft regulation issues to deal with. You might have noticed that a particular concern for southern England is the location of runways. As is quite often the case with such issues, you can get tangled up in a wider debate.

APD is not and cannot be the main thrust of these discussions. However, as I said in response to the convener at the start of the session, there is a key reliance on the political will to drive these things, and the signs that I have seen at UK party level as well as from the Scottish parties suggest that a political will is present that I have regretted not seeing in the past.

Jamie Hepburn: Let us not make APD the thrust of the question, then. You would accept that the nature of devolution is that it is reliant on the UK political parties. It might be that, as you have said, there is a will, but there is no guarantee that we will see this devolution, is there?

Professor Trench: Well, there have been the political guarantees from each of the parties and the statements that the three Scottish leaders made collectively a week or so ago when I was overseas. The Lib Dem position was, of course, drawn up by Menzies Campbell, a former leader of the party at UK level; I gather that there were extensive consultations between the UK and Scottish parties on the framing of the Scottish Labour devolution commission; and there is clearly, as the Prime Minister demonstrated when its report was published, significant support from

the Conservative Party for the Strathclyde commission.

Jamie Hepburn: A UK minister said to us that the Strathclyde commission had made a welcome “contribution to the debate”. Would you not view that statement, as I and others would, as meaning that the commission was being kicked into the long grass?

Professor Trench: The last time I looked, the Prime Minister batted rather ahead of the Exchequer Secretary to the Treasury in the political order.

Jamie Hepburn: The Prime Minister had better have a word with Mr Gauke, then, because he must not have been sticking to the message in his evidence to us. Is that not right?

Professor Trench: You had better recall Mr Gauke and ask him that question.

Jamie Hepburn: I believe that we might be doing so.

The Convener: We have asked him to come back in August to discuss another issue.

Malcolm Chisholm: One of the main issues that has emerged from both of you is the importance of transparency in relation to the Barnett formula. I notice that in his submission Alan Trench says that he refers to the issue in “Funding devo more”, which contains suggestions about

“greater transparency ... and greater scope for impartial intervention and review of decisions about the formula.”

I know that you will be shocked to hear this, but I have not read chapter 7 of “Funding devo more”. I am not asking you to give a full account, Professor Trench, but given that this issue has emerged as perhaps the main theme of this morning’s discussion, I think that it would be helpful if you could at least reassure us that there are concrete ways of dealing with the problem. I have no doubt that Professor Heald also has some suggestions.

11:45

Professor Trench: Chapter 7 of “Funding devo more”, which I would be happy to read for the benefit of the *Official Report* if members so wish, is headed “Institutional implications of reform”. It looks in particular at two issues—arrangements for tax collection and wider arrangements for the remaining grant element. “Funding devo more” talks about a very different approach to grant from the Barnett formula. I draw your and your colleagues’ attention to what it says in chapters 5 and 6 on that front.

On the institutions, there are some strong arguments for continuing to use HMRC as a tax collection agency for VAT—I think that that is

inevitable, given the EU rules—and also for income tax, because otherwise there would be a significant increase in complication for taxpayers and it is likely that many of the benefits of the PAYE system would be lost. The PAYE system makes life simple for taxpayers, but it also makes tax collection both cheap and effective for Government. Our system is rather good, for all the problems that exist within HMRC, on which I suspect you are better informed than I am.

That said, some changes would be required in the governance arrangements for HMRC, quite possibly including things such as the appointment of a member of the board so that it becomes accountable to all the Governments on whose behalf it collects taxes, rather than simply being an agency of the UK Government that happens to hand over to one of those Governments a chunk of the revenue that it collects. An independent body would also need to be established to review the system in general, carry out calculations in relation to grant and manage the transparency.

The best model that I have seen comparatively for all of that is the Commonwealth Grants Commission. Professor Heald mentioned the Australian approach, and on the level of how the grant is calculated I entirely agree with him. The system is wide open to gaming, it is quite expensive to run and it is unwieldy, but the role of the Commonwealth Grants Commission as an institution is impressive. It is an independent commission that is appointed partly on nomination of the states and partly on nomination of the federal government.

The members are impartial and independent once they are appointed, as is the chairman, and the commission provides public, formal advice to the federal treasurer—the federal equivalent of the Chancellor of the Exchequer—who has never been known not to act on that advice. Although it is technically an advisory body, its advice is extremely authoritative and any departure from it would be public, conspicuous and likely to trigger major political dispute. That ends up being about the best approach that is to be found from around the world, and I think that it would work well in a UK context.

Malcolm Chisholm: Professor Heald, can you say anything more about how we achieve more transparency?

Professor Heald: Basically, the Chancellor of the Exchequer has to tell the Treasury to do it.

We come back to a point that came up earlier. Scotland has 10 per cent of the population that England does, yet, as with the six nations tournament, we think of ourselves as equal to England. In a sense, Westminster and Whitehall are inevitably dominated by a London and UK

agenda. I agree with my co-witness that we need something like a territorial exchequer board to manage the mechanics, but the crucial point is that, to make tax devolution work, the UK has to bring its budget forward. There is absolutely no reason why the UK has to set its tax rates at the end of March. If the UK budget came forward to November or December, around the time of the autumn statement, which is basically another budget every year, it would be much simpler to co-ordinate tax policies at the UK and Scottish levels. The more interfaces there are between taxes that are run by this Parliament and ones that are run by the Westminster Parliament, that becomes very important.

Transparency is not difficult: there are two things about it. First, the information has to be put in the public domain at the time. Secondly, there has to be sufficient background explanation so that it is accessible to people. If the information has been published in some obscure place on the Treasury website or on page 321 of a budget document, for example, that does not necessarily help. It has to be up front and in time. It is a political will question.

Malcolm Chisholm: The other main theme of this morning is also a political will question, obviously: to what extent—and how soon—the Barnett formula would be changed if there was a no vote. I agree with Alan Trench on this; like him, I think that the views of leaders of political parties are what we should be looking at rather than at some of the other views that have been emphasised.

The other thing that feeds into this, it seems to me, is fiscal devolution. Again, I absolutely believe that after a no vote, there would be more fiscal devolution. That in itself, in the short run—and possibly in the longer run—helps to entrench the Barnett formula because, first, we have a smaller block grant in the context of fiscal devolution; secondly, when we are in a period of transition such as that, we need to have stability in the grant mechanism in order to make the fiscal changes work, which is why I think we have the no detriment commitment. Would you agree that, in fact, the context of more fiscal devolution is a reason why there will not be some dramatic change to the grant mechanism during that process of change?

Professor Trench: That is certainly an argument that will have a lot of attraction to UK ministers and UK officials, whatever its merits might be here. One of the great virtues of the Barnett formula system is that it produces stability and predictability in public spending. For all the problems of transparency, it is nonetheless better at producing stability and predictability than many other systems. Moving to greater reliance on your

own tax revenues necessarily introduces an element of volatility and I suspect that one wants to be able to manage the risks of that.

Malcolm Chisholm: The other thing that we have talked a lot about in the context of further fiscal devolution, particularly in relation to the income tax powers that we are getting, is the block grant adjustment, for which there is an agreed formula. How does that issue interrelate with our discussion about transparency in Barnett and so on? Is there not some relationship between the two?

Professor Trench: Indeed. In fact, Professor Heald has touched on that regularly in this discussion. I entirely agree with him that the mechanism needs to be very clear and as transparent, mechanical and automatic as possible once it is agreed and put in place, because if it is not you will run into the difficulties and dangers of having a soft rather than hard budget constraint. That would be disadvantageous to both sides. It is certainly likely to lead to difficulties in the medium to longer term, which is one of the reasons why people have been arguing that, in the medium to longer term, the Barnett mechanisms should be reviewed.

Whatever one does with the quantum of funding, those mechanisms are likely to get quite creaky in the event of significant tax devolution. For a start, you will be using an increasingly notional idea of the block grant as it would be under the Barnett formula, which, as Professor Heald has explained, is something that is quite hard to measure. A lot of doubt starts to emerge when, on the one hand, you try to ascertain what is going on and, on the other, you use necessarily notional estimates of what tax revenues would be if tax decisions in Scotland had not been made.

With such levels of notional calculation, some quite significant accountability and transparency issues can arise, and the mechanism outlined in “Funding devo more” is an attempt to get round those. Key to that are mechanisms for periodic review to avoid exactly the situation that Professor Heald highlighted with regard to council tax and the absence of revaluation. Such things go badly wrong when they are not kept in good order, and if they are to work, they need to be periodically maintained and reviewed.

Malcolm Chisholm: I have two final points for Professor Heald—one that looks forward and one that looks back. His submission states:

“NHS expenditure in England is projected to fall by 9.1%”.

That is the real-terms age-adjusted figure, which is an interesting concept. Surely, however, the fact that health expenditure is rising with inflation benefits the Scottish Parliament because of the

significant consequential that flow from English health expenditure.

Professor Heald: The answer to that has two parts. One advantage of the system for Scotland has been that the big cuts in local government budgets in England and in the budgets for education, law and order and justice have been significantly offset by increases in the English health budget. The Cabinet Secretary for Finance, Employment and Sustainable Growth has therefore had the option of not penalising local authorities anything like as harshly as has been done in England. That is a good example of the significant protection that comes from things going into a pool of money and decisions being made in Scotland on how to spend it.

Malcolm Chisholm: The figure comes from the Institute for Fiscal Studies. However, the concept of age-adjusted health expenditure seems a bit misleading, given that spending is still increasing in line with inflation. We all know that it is not enough, but it still helps the budget of this Parliament.

Professor Heald: I am sorry—I forgot to cover that point in my answer. That is a pretty big signal from the Institute for Fiscal Studies that it does not think that the UK plans are sustainable. The figure goes through to 2018-19, which is beyond the period for which detailed plans are available; the spending review in 2013 only covers the period up to 2015-16. I think that the IFS is trying to send a signal that the approach is not sustainable. It is clearly making the point that, even with the ring fence in real terms on English health expenditure, we have to take into account what in the jargon is called the relative price effect, which means that costs go up faster in health than in the economy as a whole, as well as the effect of the changing population composition. The IFS is trying to signal just how tough the plans are, even with protection, and that after the next election the projected forward plans will be extremely painful.

Malcolm Chisholm: I agree, but that is mainly a point about the nature of health expenditure, which would be the same whether we were part of the UK or independent. There would be no difference in that regard.

Professor Heald: That is right.

Malcolm Chisholm: My final point looks backwards and relates to your interesting point about temporary Barnett consequential. I remember arguments about the baseline stretching back, but surely the point is that a change in the baseline would simply reflect a corresponding fall in the English baseline, so it is not really a change to the Barnett formula itself—it would be a change only if there were a relative advantage to England over Scotland, as happened

with the Olympics. Although people always argue about changing the baseline, that is not really a change to the Barnett formula, is it?

Professor Heald: I understand your point about the relative position with England, but the approach is a way for the Treasury to impose cuts on future budgets without being open about what is actually happening. However, I agree that it does not affect the relative position between Scotland and England. If you are suggesting that the reversal goes back through the formula in the way that the original amounts came through, I agree.

Jean Urquhart: Professor Trench, you equate a no vote with a rejection of full fiscal autonomy. Is it fair to say that you believe that devo max could never be achieved under the union?

Professor Trench: Yes. To the extent that full fiscal autonomy is necessarily part of that maximal form of relationship that would involve the UK Government being responsible for defence, foreign affairs, international aid and conceivably immigration, but nothing else in relation to Scotland, that is incompatible with the union. A no vote in the referendum is also a rejection of that option.

12:00

Jean Urquhart: Would you say that the plans that have been put forward by the no parties are devolution for devolution's sake and that some powers will be transferred not necessarily to get things right financially but to get things right politically?

Professor Trench: I cannot comment on what might happen in the future after a no vote and the process that would follow. "Funding devo more" is about trying to find a workable model for further devolution—I do not know what the phrase "devolution for devolution's sake" means.

Having looked at the evidence, particularly the Scottish social attitudes surveys over a decade or more, I think that it is clear that Scottish voters like devolution and want more of it. They want extensive self-government within the union, not outside it. That does not necessarily appear to include devo max, although it conceivably might. However, I do not think that that is acceptable on the other side of the equation. The question is how we can establish a workable scheme that, broadly speaking, corresponds with the preferences of Scottish voters but which is also compatible with their other preference, which is to remain within the UK.

Professor Heald: One must remember that, although Scotland and England are remarkably alike, Wales and Northern Ireland are on average

much poorer in, for example, GDP and fiscal capacity. As far as Scotland is concerned, you could run fiscal devolution without worrying too much about equalising the tax bases. However, the potential yield per head of income tax in Wales is significantly below the levels in Scotland and England.

What will emerge in debates after the referendum is the question of how whatever one gives Scotland affects what is possible in the future for Wales and Northern Ireland. In a sense, Wales and Northern Ireland have been carried along by Scotland for the past 20 years. However, not only are Wales and Northern Ireland much poorer than Scotland; Wales, in particular, is much more economically integrated with England than Scotland is with regard to the tax system. The Holtham commission produced a wonderful diagram showing the proportion of the population that lives within 25 or 50 miles of the border. The England-Scotland border is not highly populated, and it would be much more difficult to run a separate tax system in Wales.

Scotland should be thinking about not only what is good for Scotland, but what the implications are for a possible extension of certain parts of the scheme to Wales and Northern Ireland.

Professor Trench: That is an explicit part of the design of the devo more project. It has been deliberately designed to establish what is workable across the UK as a whole, not simply in Scotland, with the expectation that Scotland will be the first in line but not necessarily the only part of the UK to be in the line.

Jean Urquhart: I cannot remember the context now but, Professor Heald, you said that you have been pushing for some changes to or clarity on taxation for the past 20 years. Would you say that devolution in Scotland and the advent of the SNP majority Government have forced people to consider all the issues seriously? Would you also say that, in a country with a very complicated tax system that is, I believe, desperately in need of change, this is a fantastic opportunity for that change to happen?

Professor Heald: The fundamental problem in the UK is the fact that people tend to want Scandinavian levels of public services for American levels of taxation. There is something of a misalignment between people wanting to spend more and their wanting to reduce taxes. That aside, your basic point is correct. The fact of the SNP majority Government bringing about a referendum has put the issue back on the political agenda.

The argument about the right way to fund a devolved Scottish Parliament goes back to the 1970s. As I have said, I have been an enthusiast

for tax powers for a devolved Parliament since the 1970s, when almost no one else was keen. However, although I remain supportive of that approach, I believe that we need to think about how the system as a whole works. I therefore agree that this is a window of opportunity. Indeed, it might well be another push in the same way that 18 years of Conservative Government in the 1980s and 1990s was the push for the Scottish Parliament happening in the first place.

Jean Urquhart: Referring to the Barnett formula, you alluded to what I assume was political irritation at the Scottish Government not imposing tuition fees. Is the whole point of devolution not that a country can have different funding priorities?

Professor Heald: I could not agree more, but the fact is that policy variation in Scotland is always seen as involving more expenditure. People have then made a further step and argued that Scotland can afford such variations because it is overfunded in the first place. That is the logic behind the position that I described.

Jean Urquhart: And no one ever corrects that logic.

Professor Heald: Successive Scottish Governments have been nervous about a needs assessment. Since the 1978 assessment, which was published in 1979, some informal as well as rather more systematic exercises have been carried out within the Treasury, but they have never made it into the public domain. Scottish Governments have been nervous about opening up the issue, not least because if there were a needs assessment, it would become—contrary to what, for example, Gerald Holtham thinks—an incredibly time-consuming exercise. Once the process started, it would grow legs of its own and become long and painful.

Jean Urquhart: Do you agree that that could be avoided with a yes vote?

Professor Heald: I am not here to express constitutional preferences.

Michael McMahon: Thank you very much for your evidence so far, gentlemen—it is good to hear from experts this morning.

Professor Heald, you mentioned the desire to have high levels of public expenditure at low levels of taxation. In paragraph 12 of your submission, in relation to the implications of extra tax powers, you make what you say are four highly relevant observations. The fourth, which is in subparagraph d), is that

“Claims that lower tax rates would be self-financing through higher economic growth should always be treated with suspicion.”

That is exactly what is on offer to us. We are told that, regardless of what fiscal deficit Scotland might have, we will not need to increase taxation and that we can continue to spend more because there is a magic bullet of lower corporation tax, which will solve all our growth and financial problems. Should we treat that claim with suspicion?

Professor Heald: Yes. We need only go back to the time of Ronald Reagan in the United States. When people start arguing that you will get enormous supply-side effects from reducing taxation, you should be suspicious. What you may do, as Ireland and Luxembourg have done, is attract corporate tax domiciles. Therefore, you may get significant increases in your corporation tax revenues without much benefit to the economy.

I get very annoyed when people—on posters, for example—compare countries' GDP. GDP is a useful concept, but you must understand what is involved. Countries such as Ireland and Luxembourg have enormous differences between gross domestic product per capita, the levels of which are enormously high, and gross national income per capita, the levels of which are much more suppressed, because there are claims of foreign residents on the production. In the case of Scotland, the North Sea is a very significant example, as the income is generated in the North Sea but a lot of it does not come to Scotland, because the people who work there are not necessarily Scottish residents and the companies are foreign owned.

The Mirrlees report has already been mentioned. A well-designed tax system may have beneficial effects on the economy. However, that is different from playing around at the edges with either corporation tax, which is going down rapidly everywhere—so you cannot reproduce the Irish miracle with corporation tax, because the trend internationally is for corporation tax to fall quite dramatically—or with air passenger duty, which may lead to some recirculation of journeys from English airports to Welsh airports or Scottish airports, but you should be careful about the extent to which that is a real economic benefit or just a transfer.

Michael McMahon: Do you have an opinion on that, Professor Trench?

Professor Trench: I do not have a lot to add. As Professor Heald says, the hazard with reducing corporation tax is that you get what is known as brass plating to little economic utility. That applies whether the power to adjust corporation tax is devolved or exercised within an independent state.

Michael McMahon: We have heard in previous evidence to the committee on the argument about

lower corporation tax that the margins that have to be extended in order to get the benefits—if there are any benefits—have to be quite extensive. The Scottish Government is proposing that, whatever the corporation tax rate is across the rest of the UK, it would maintain a level 3 percentage points lower than that. However, the evidence that we have been given is that although the difference between the rates in, for example, Germany and Ireland is something like 18 per cent, it is still not significant in attracting inward investment. Is that the level of difference that is required before any financial benefit is gained from corporation tax in relation to competition?

Professor Trench: That is certainly one element. Professor Heald has mentioned the Irish miracle. It is fairly clear that that was dependent on a number of factors. One of them was a young, skilled, English-speaking workforce. Another was that the miracle more or less coincided with the completion of the European single market, so by using that combination of incentives, Ireland was able to market itself as a very attractive place for North American corporations in particular to do business, as they could gain access to a dramatically expanding European market in a relatively friendly way, because they had access to an English-speaking workforce.

First of all, that trick has already been pulled and it is likely to be a one-round exercise, so Scotland would not be able to replicate it. Secondly, we all know how that story ended. Part of the problem was that the economic boom that was triggered turned into a real estate boom that went spectacularly badly wrong and affected not only private finance but public debt through bank bail-outs. Ireland offers more lessons for caution than for optimism.

As Professor Heald says, corporation tax is a tax that is declining over the long term. One of the reasons why I think that, of the options that are available, assignment of VAT is a very attractive one, is that VAT is a growing tax. You should go for a growth tax rather than one that is shrinking.

That is why, in Australia, the goods and services tax was deliberately sought by the states to be the underpinning for the redistribution system for their funding, because they wanted access to a tax that was growing over time. What happened shortly after the present form of the system was introduced was that, because tax receipts had been increasing so dramatically with the GST, the federal treasurer tried to get his hands on them and had to be fought off. He decided that the deal that had been offered was not such a good deal after all, but he was fought off and the states continue to benefit from the increase in that pool of revenue.

12:15

Michael McMahon: That is an interesting argument, and it is one that we have discussed. We have had evidence that using VAT would be a better way to use tax-raising powers to benefit Scotland, but we would have to do that in the context of the UK being the member state of the European Union, so I foresee a problem. You gave the example of Australia. Would the European Union permit such an arrangement? Have any EU states taken that approach?

Professor Trench: The Australian system as such would be perfectly capable of being applied elsewhere if the conditions were right. I do not think that the Australian model would be right in a UK context, because the UK has decentralised much more spending responsibility than Australia has and is a significantly more unequal country.

Australia is a remarkably homogeneous country, with a couple of pockets of quite serious poor tax performance and high spending need. One of those pockets is Tasmania, which is reasonably but not very populous; the other is the Northern Territory, which is very empty indeed. Otherwise, Australia is really very homogeneous. It shows some patterns of change over time—again, in contrast to the UK—in which states are the more prosperous and which are the less prosperous.

GST is a consistent tax across the whole of Australia, so if the UK wanted to import the Australian model, I do not see why it could not do so, as a matter of principle, subject to certain fairly limited adaptations.

Michael McMahon: That is helpful. Thank you.

Gavin Brown: Professor Trench, in paragraph 20 of your submission you discuss the timescale for implementation of fiscal devolution. In response to the convener's questions, you clarified that the period of 15 years that you mentioned related to capital gains tax and national insurance, and that you thought that other measures could be implemented "relatively quickly". For the record, what do you mean by "relatively quickly", for example in relation to income tax?

Professor Trench: As I said, I mean three to five years. Devo more is a programme rather than a simple, one-shot arrangement.

I mentioned CGT and national insurance; it is perhaps also worth mentioning alcohol and tobacco duties. There is a strong case for devolution of tax on alcohol, in particular, to get round some of the problems that minimum pricing introduces and because of the social problems that arise from alcohol consumption in Scotland. However, there are real difficulties with doing that, which arise from EU law, as well as from the treaty

of union, which said that there must be a single level of excise duty in the new United Kingdom.

The EU rules are fairly significant. The issue can be addressed in two ways. One way is through a sequence of bodes and workarounds, to try to create a tax charge that inflates the price and brings revenue to the public purse, as part of the mechanism of using price to discourage consumption. That is a convoluted way of achieving a goal that I would rather achieve directly, if one could do so.

The direct way would be through some sort of supplemental sales tax, but that would conflict with the EU rule on a single VAT. I suspect that that is one of those rules that might be capable of change in the right circumstances, if the game were played in the right way. It would be a significant change at EU level, and one would need to play the EU game very astutely and recruit the appropriate allies. However, a number of EU member states have an interest in fiscal devolution, so I would not regard that approach as a lost cause from the outset, however difficult the path to ending single VAT might be.

Gavin Brown: Is the timescale for the assignment of VAT receipts similar to your timescale for devolving income tax? In other words, would it take three to five years?

Professor Trench: If anything, it could be done much more quickly. The tax would continue to be collected by a single agency, so the question would be how one worked out the appropriate apportionment to Scotland and the mechanism for apportionment. We have figures in GERS that are based on an understanding of how much VAT revenue is attributable to Scotland, but the numbers would need to become much more robust and the mechanism for calculating them would have to be agreed between the two Governments involved.

Gavin Brown: One of your reasons for suggesting that that should happen with VAT is that it is not a volatile tax. Obviously, one can study the figures, but can you give us a rough estimate of how volatile VAT is compared to income tax?

Professor Trench: There are some figures on that in table 4.3 of "Funding devo more", which tries to show the volatility of VAT, income tax and corporation tax at UK level and for Scotland, Wales and Northern Ireland. I am hesitant to give a definitive answer, because the numbers that I used at that point were the best that we had at the time and they are now a couple of years out of date and the methodologies have changed. With a recession as deep as the one that we have been through, the result depends very much on when exactly you start and when you stop, because that

can introduce a significant skew. However, in aggregate and broadly, VAT is roughly as volatile as income tax.

While working on “Funding devo more”, one thing that I was intrigued by and thought was a useful fact is that the two taxes run on different cycles. VAT receipts took longer to fall than those from income tax but came back somewhat later. That means that the two, taken together, help to balance out each other’s volatilities. As part of a package of funding, that strikes me as a way of using one tax to help to manage a risk from another in a way that ought to be attractive from the point of view of a finance minister.

Gavin Brown: Your submission says that the revenues that are collected from VAT will grow. I suppose that it is hard to predict too far into the future, but do you think that they will grow in the short to medium term and the long term? Broadly, do you see growth in perpetuity?

Professor Trench: I do not know about in perpetuity, but it is fair to say that, in the medium to long term, taxes such as corporation tax will be under serious pressure on a worldwide scale. The burden of taxation is shifting towards indirect taxes such as VAT.

Gavin Brown: Professor Heald, you have said that we ought to be cautious about assignment. To be clear, are you against the idea of assigning VAT, or are you saying that we should be cautious and ensure that it is done as part of a package, because, as I think you said, there would not be the same accountability factor?

Professor Heald: My point was that there comes a public confusion about revenues that you raise and have control over and revenues that you do not have any control over. With assigned VAT, you would have no control over the amount of revenue. If there is a recession such as that in 2008, you will have to have quite deep borrowing powers. Obviously, one does not want to adjust spending sharply downwards during a big recession. Clearly, if there is assignment, there has to be some kind of borrowing mechanism. That might be an external borrowing mechanism, or it might be within the funding system of the relationship with the UK Government.

The point that I keep making is that I worry about people’s enthusiasm to have more tax powers, when that might end up with a system in which the tax powers are unusable, they ossify, the administrative infrastructure collapses and then, when the finance minister wants to use them to put taxes up or down, he finds that he cannot.

Gavin Brown: That may have happened a couple of years ago in Scotland.

I am particularly interested in your points about the Scottish rate of income tax and the suggestion that a deadline of late autumn will be set for the Scottish Government and Parliament to outline what the rate will be. The committee has touched on that and we will be doing work on it over the next year or so. To try to get round the issue, the UK budget could be brought forward to November or December—which you alluded to—the Scottish budget could be delayed, or the deadline could be changed so that the rate has to be announced not in the autumn, but in the weeks leading up to the budget. There are different ways round the issue. How much thought have you given to how we might solve the problem, which I think is pretty important? Do you have anything else to say on it?

Professor Heald: The point that I made is that, once the Scottish Parliament decides to use the tax power differently from the Calman 10, the question that will immediately arise is about what the UK Government will do in March that will affect the yield or the political acceptability of the change. The Office for Budget Responsibility says that income distribution in Scotland differs from that in England—particularly from that in London and the south-east. Scotland has fewer very high tax payers and more low tax payers. The distribution of where revenue comes from is different. Any decision that is taken about thresholds and whether they are indexed, for example, will have significant effects.

I have also made the point that, in the public’s mind, not much distinction is made between national insurance—as an economist, I regard it as a tax, anyway—and income tax. The question is what the UK Government will do. When Gordon Brown was Chancellor of the Exchequer, he was keen to say that he would not put up income tax rates, but he put up national insurance contributions.

The Scottish Government’s budget calculations and the calculations of political credibility and acceptability could be messed up. It would be hugely beneficial to the UK to pull forward the UK budget, which would enable a sensible debate to take place in Scotland and in the UK about budget changes. In the UK Parliament, chancellors survive on pulling things out of the hat without their having had any parliamentary consideration. Significant mistakes in UK budget policy—in my view, the introduction of the 10p rate and its cancellation were misguided policies—arise because of the pressure on the chancellor to do something. The so-called Lamborghini exemption—the decision that people do not have to put their pensions into annuities—is another example of that.

The chancellor in Westminster is under great pressure to have something exciting to put in the

budget. I would regard as a good budget one that is not exciting, because the tax system must be managed in the medium to long term. However, there is the danger of having remarkable amounts of silly churn. I suggest bringing forward the UK budget and having a proper parliamentary process at Westminster—I proposed a tax and spend committee to the UK Parliament recently—that would involve the chancellor producing a draft budget. It is clear that some tax measures cannot be announced in advance, because people would evade or avoid them, but quite a lot of things can be announced in advance. Such a process would mean much more serious debate at Westminster about thresholds and rates.

Successive Governments have obsessed about not putting up the basic rate of income tax, while they have allowed fiscal drag to take into the higher rate 3 million more people who earn what I would regard as relatively modest income levels. I suggest bringing everything forward at UK level and having a serious parliamentary debate about the budget. Part of a chancellor's political power, however, involves not telling people what will be in the budget.

Professor Trench: I quite understand the concern about UK-level decisions having an impact on the Scottish public finances because Scottish tax decisions have already been taken. In principle, the approach that I understand has been agreed for making the tax adjustment in the block grant—the so-called indexed deduction route—is supposed to allow for such changes in the tax base.

If that approach works properly, it has the further advantage of reducing the significance of the guarantee of the no-detriment principle. A shift would be made to what should be an arithmetical figure, because the overall base, and not components of it, would be looked at. However, whether that would be the case is another question—one which I strongly recommend the committee look at. That is the principle that lies behind the approach to reducing the block grant to allow for the Scottish rate of income tax.

Gavin Brown: Professor Heald, your statement that you

“regard as a good budget one that is not exciting”

is a quotation that I might borrow at some point, if that is okay.

12:30

Finally, in your submission you talk about the “weakening of local government”—at least from a financial point of view, in that its tax powers are lower than they were 10 or 15 years ago. That is an issue that will have to be addressed in Scotland

whether or not we become independent. It is also an issue that will have to be addressed in England, Wales and in Northern Ireland. Have you done any work on how that might be addressed or are you simply flagging it up at this stage?

Professor Heald: I am simply flagging up the issue. My knowledge of local government finance has deteriorated over the years. A property tax is a perfectly sensible tax for local authorities, but the political system above local authorities must not make the power unusable; the power of setting council tax has, effectively, become unusable for local authorities. I am concerned that a devolved income tax might mirror that and also become unusable.

Clearly, what is needed in council tax is a regular cycle of revaluation. All the discussion four years ago about a mansion tax was completely misguided because we could very easily break up the top bands of council tax. Incidentally, most of the benefit of that would go to a very limited number of local authorities, which would probably have to go through the equalisation system anyway.

There is a political problem in that whenever we do a council tax revaluation, people assume that their bills will go up. Some people's bills will go up very significantly because of the misalignment between the existing bands and the reality of the property market. We have to have a mechanism at Scotland level and at England level—there will probably be quite tight central control for a period to ensure that average tax rates do not go up. It will be a minimum of 25 years before anything is done, so the damping process to ensure that people do not get hit with a really big bill increase will be over the long term.

Gavin Brown: Thank you.

John Mason: The witnesses will be glad to know that I am the last committee member to ask questions. Professor Trench has talked about a lot of different taxes over the last couple of hours. You were pretty positive about controlling VAT because it is growing, and about controlling alcohol duty because it is linked to a social issue that we need to address in Scotland. Neither of those can be controlled under devolution because of European Union rules. Are you saying that that would be a strong argument for independence?

Professor Trench: No. I am saying that to finance a devolved Government within the UK—given how the UK works and its various constraints—that appears to be the best mechanism, but these are the difficulties and this is how you might address them. The decision about whether Scotland should become independent or not is certainly being taken above

my pay grade and, I suspect, above yours. It is being taken by the people of Scotland.

John Mason: Okay. That is helpful. Thank you.

Professor Heald—you mention in paragraph 14 of your submission some of the “frightening” prospects of cuts in UK expenditure. Do we have any actual figures? You specifically mention the projected 9.1 per cent reduction in NHS expenditure in England. What would those cuts mean for the Scottish budget?

Professor Heald: There are no numbers because of the UK general election—the 2013 spending review dealt only with one year, so there is only disaggregation of spending for one year, but there are totals for the next three years. The IFS and the Office for Budget Responsibility have projected those numbers, given Government statements about totals and protection of health and schools expenditure. An element to consider in relation to those numbers is that the OBR and the IFS are flagging up questions about the sustainability of the numbers and whether it is really possible to reduce public expenditure in those areas by so much. There is a kind of political flagging going on there. However, if that happens with the continuation of the Barnett formula, it will produce negative Barnett consequentials.

The UK as a whole is facing a decision about whether it wants to pay taxes or go to a level of public spending as a proportion of GDP that was last seen—according to the IFS, I think in 1948—despite the fact that we know, from all the fiscal sustainability projections, that demographic change, including the proportion of older people and the effects of that on health expenditure, means that there will be intense pressures. The Scottish Government has softened some of the sharpness of what happened in England through expenditure flexibility. Scottish local government might think that it has had a bad time, but it has had nothing like as bad a time as northern industrial cities in England have had. That has been an advantage of the discretion that Scotland currently possesses.

John Mason: A decision by a future UK Government—over which we would have little control—to reduce expenditure would, inevitably, flow through to Scotland, as you have just said, through the Barnett formula. Therefore, we would be hit by the actual cut and, on top of that, by changes in the Barnett formula.

Professor Heald: No. Such things would come through as Barnett changes.

John Mason: They would come through as Barnett changes but, if the Barnett formula was reorganised—

Professor Heald: If something took the place of the Barnett formula and it was assumed that Scotland is currently funded too generously, there would be that to deal with as well.

John Mason: Therefore, there would be two things: there would be the real cut plus the Barnett reorganisation.

Professor Heald: Yes.

John Mason: Professor Trench’s submission mentions welfare—first, in paragraph 5. Are you assuming that welfare could not be devolved to any greater extent, or are you just forecasting that there will not be an appetite for that?

Professor Trench: As you may know, we have also done quite a lot of work on welfare through the Institute for Public Policy Research project. Earlier this year, we published a report called “Devo more and welfare: Devolving benefits and policy for a stronger union”, which addressed those issues in detail. It recommended devolution of some benefits, including housing benefit and attendance allowance, and a power for devolved Government to provide supplemental cash benefits from its resources, if it wished to do so. It also recommended that, if Scotland remains in the UK, there should be an on-going social union that embraces key elements of the redistributive welfare state—notably old-age pensions and benefits such as the jobseekers allowance and the disability and incapacity benefits.

Another implication of a no vote is that remaining in the UK will mean that there will remain a substantially UK-wide welfare state. However, particularly under a model that included the power to supplement welfare, there would be extensive scope for Scotland to provide more generous levels of welfare benefits, if it saw fit to do so. The rights that were part of the social union would continue to exist across the UK and be held in common by all UK citizens, whether they live in Scotland, England, Wales or Northern Ireland. That is the essential presupposition.

We found it quite hard to work out how more benefits could be devolved in other areas of welfare even if that were desirable, outright. That would be problematic in a number of ways and would impose asymmetric risks, given the nature of welfare spending and the ability of the larger Government to manage it better because it has access to a wider tax base.

Professor Heald: Over the past few years, there has been a challenge to long-standing concepts of territorial equalisation in the UK, which I have emphasised in the context of England. London and the south-east transfer significant revenues to the rest of England and the affluent areas are more questioning of their transfer to poorer areas than they were previously; we could

argue that, at individual level, people who are well off are more questioning about transfers to people who are less well off.

However, there is often controversy in Aberdeen and the north-east of Scotland about Aberdeen not being as well funded as, for example, Glasgow—even within Scotland, there are arguments about who gets the money. There are equalisation issues at UK level and within the UK.

To return specifically to John Mason's question about welfare, I do not quite know where the line exists, but I have some sympathy with the view that national insurance and social security probably belong to the higher level. That is a troublesome issue in Belgium, where most public services are devolved but social security is still operated at a federal level, under challenge.

There is a question of how far we go. As people individually and territorially start wanting to keep what they kill, reluctance to make the geographic transfers becomes greater.

John Mason: Yes. That is what I am interested in. The argument seems to be that welfare is so fundamental to the UK that it must be kept centrally. Some people would make that argument for the NHS as well, but the NHS has been devolved and we see some differences in the way that it is going. On top of that, even though welfare is not devolved, the two largest parties in the Scottish Parliament agreed that we do not like the bedroom tax and £50 million was found to deal with that. If there is a desire to go into that policy area, why are the NHS and welfare different?

Professor Trench: It is partly that we are where we are. The NHS was devolved in large part because the administration of it was a matter for the Scottish Office, whereas welfare has been in the hands of the Department for Work and Pensions and its predecessor department since the welfare state was created. The NHS in Scotland was always administered by the Scottish Office, and devolution built on those roots.

I suspect that many people think that the way in which the NHS was devolved was probably not the best way of doing it in that it might have been a good idea to have written into the settlement some high-level definition of what the NHS should be about, so that its purpose would have been defined as being to provide universal care free at the point of use. As matters stand, it would be completely open to the Scottish Parliament to abolish the NHS if it wished to do so. There is, obviously, no political will to do that, but that choice would be open in Scotland as it is in England.

The difference is that, in England, there is access to a wide range of other policy levers to shape and implement some replacement for

healthcare that would be much harder to find in a Scottish context. Let us take your example of the bedroom tax or spare room subsidy. You found a way through that, but you had to find a rather intricate solution that involved a measure of legal accommodation by the UK Government to ensure that it could happen. I would like there to be a much more straightforward way to accomplish similar ends, and that is the purpose of the supplemental welfare power.

John Mason: You would support the transfer of some welfare power but not everything.

Professor Trench: Indeed. As I say, a power to provide supplemental welfare is key to the devolved model. If Scotland decided that UK levels of welfare benefits in a particular area were inappropriate, it would be able to supplement them if it could find the resources.

Professor Heald: I will address your question about why the NHS is different from welfare, Mr Mason.

Psychologically, people distinguish between cash benefits and services in kind, although it might not be entirely rational that they make that distinction. There will be strong political opposition in the UK and in Scotland to differentiating old-age pensions according to which part of the UK people live in. Even though the purchasing power of old-age pensions varies a lot depending on where people live, there is a reluctance to depart from cash transfers in the same way that there would be political opposition to a regional minimum wage that offered, for example, a minimum wage that was lower in Glasgow and Newcastle than in more prosperous parts of the UK.

12:45

John Mason: The living wage is regional, is it not? It is different in London.

Professor Heald: The minimum wage is not. At the moment, the living wage is a voluntary mechanism, and there is a reluctance to go that way. As has been said, Scotland has always had its own administrative institutional structures for the NHS, but the relationship between cash and services is a difficult one. My instinct is that welfare should not be devolved to a Scottish Parliament, but there will be areas in which you might take a different view. For example, housing benefit has a clear connection to a devolved function, and that is an area in which you may well manage the system much better. However, there are areas in which the choices are quite difficult. I would be sympathetic to certain choices, but I still think that the unified social security system is an important part of the union.

John Mason: If we asked Scottish pensioners whether they wanted to stay with the UK pension or whether they would take £1 more from the Scottish Government, I bet that they would all want devolution.

Professor Heald: The obvious question is how you would finance that £1 more. That is the point—everybody is keen on spending more money, but nobody tells me how you would raise that extra money.

Professor Trench: “Funding devo more” would let you provide an extra £1 to Scottish pensioners if you wished, although the administrative costs of providing an extra £1 would probably exceed any benefit.

John Mason: Professor Trench, in paragraph 20 of your evidence you mention the national insurance fund. There is a misconception about national insurance, as people think that there is a fund sitting there with all their contributions in it. You have also argued against Scotland handling national insurance and income tax together, but it seems to me that combining the two would be a huge step forward that would allow us to simplify the system, which would help business.

Professor Trench: I am not sure that it would. I do not know how much you know about the nature of the national insurance fund. When I started this work, I knew very little about it. Like Professor Heald, I regarded national insurance as, in essence, a tax under a slightly different name that was in some vague way tied to the contributory principle that we all knew was not very serious. However, when I dug into the matter, I found that there is an entity called the national insurance fund and that national insurance contributions from both employers and employees are paid into it. That contrasts with the situation for all other sources of tax revenue, including capital gains tax, corporation tax and income tax, which are paid into the consolidated fund. The consolidated fund could be regarded as the master account for taxation.

The way in which the devolved block grant works is that an appropriation to the Secretary of State for Scotland is made by an appropriation act at Westminster, and the secretary of state then passes that money into the Scottish consolidated fund, which was established under the Scotland Act 1998. That is the accounting mechanism. The national insurance fund stands wholly, or very largely, outside that structure. It is a separate fund. National insurance contributions are paid into it and various national insurance liabilities are paid out of it.

We should note first, however, that the national insurance liabilities are defined in an odd way that derives from the statutes that created our structure

of national insurance but that does not correspond to a modern understanding of it. For example, a contribution is made to the NHS out of the national insurance fund to cover certain maternity services even though the NHS is funded out of general taxation. Secondly, in something like three years out of five there is a deficit in the national insurance fund, and that deficit is made up from general taxation because behind the national insurance fund stands the consolidated fund.

That account of how the system works is not the same as our conventional understanding of what the system ought to be, and you would need to make some quite extensive administrative changes to redress that. As I said earlier, the most recent changes to the national insurance fund were made as far back as 1975 and were fairly limited in extent. Once you get into it, it is a long and complicated story.

John Mason: You are putting the case for the whole thing needing a serious examination, quite apart from the question of independence and devolution. Do you think that the whole thing needs to be looked at seriously?

Professor Trench: I think so. Recent work by others in the IPPR has mentioned the nature of the contributory principle and how it should operate in the UK welfare state. However, the moment that one enters the debate about restructuring the national insurance fund, one gets into a much wider debate.

John Mason: Do you think that there is an appetite to change that system in the next few years?

Professor Trench: I think that there is. I do not know the timescale on which it will play out, and I would not want a scheme for the substantial enhancement of devolution to be held up pending the resolution of such complicated matters, which have been shelved for a long time and possibly with good reason. The issue of enhanced devolution is too pressing to allow for that.

John Mason: I have a final question. We have talked about the Barnett formula and how much resource Scotland should get on the basis of need and all sorts of things. Are there other factors in the equation? For example, Scotland contributes more, therefore Scotland should get more. If Scotland votes no, should we get a bonus as a thank you? How about that?

Professor Trench: A loyalty bonus.

John Mason: That is right. How about a bonus for holding nuclear weapons, given the extra risk that is involved? I would ask for about £4 billion a year for that. Surely, in looking at future finances, there are other factors apart from just need.

Professor Trench: Devo more is not simply about need. There are other factors, of which devo more tries to address quite a number. Things such as a loyalty bonus and a nuclear weapons bonus are not on the cards, though, and I am not sure that those suggestions were advanced entirely seriously.

The argument that Scotland should receive more because it contributes more assumes that that is the case, which is a fairly debatable point. In any case, one could say that that is pretty much where Scotland is now. That is not the rationale for the system or the way in which it is meant to work, but it appears to be where Scotland is at present. Whether that remains the case in the future will be a matter for further discussion, I suspect.

Professor Heald: That is a territorial political question. I will give two examples. Canada and Australia are two federations that look quite similar. Queensland and Western Australia do not benefit from their natural resources. They benefit from the economic base but not from the tax revenues because those are largely equalised away by the Commonwealth Grants Commission. In contrast, the fact that Alberta is the oil province of Canada means that it is incredibly rich. For example, it has a much lower income tax rate than those of many other Canadian provinces.

One factor that distinguishes those two examples from the United Kingdom is that they are massive countries that cover big distances, which makes the tax system much easier to operate in certain ways. The question is a political one. If the oil is in Scotland, should Scotland keep it? If the oil is in Shetland, should Shetland keep it? One can point to international examples such as the ones that I have given, in which, partly because of constitutional provisions that were in force when the oil was found, Alberta keeps it and Queensland does not.

John Mason: That is helpful.

The Convener: Thank you. That concludes questions from the committee. Does either of you want to make any final points?

Professor Trench: Thank you very much for giving us the opportunity to appear before the committee.

Professor Heald: I concur.

The Convener: Thank you. Your evidence has been first class, and we have had an interesting discussion.

We have decided to take the next three agenda items in private.

12:54

Meeting continued in private until 12:59.

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