The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

FINANCE COMMITTEE

Wednesday 5 November 2014

Session 4

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CONTENTS

Col.

FURTHER FISCAL DEVOLUTION 1
DRAFT BUDGET SCRUTINY 2015-16 30

FINANCE COMMITTEE
27th 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)
Professor John Kay (London School of Economics)
Professor Ronald MacDonald (University of Glasgow)
Peter Reekie (Scottish Futures Trust)
Barry White (Scottish Futures Trust)

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance Committee

Wednesday 5 November 2014

[The Convener opened the meeting at 09:30]

Further Fiscal Devolution

The Convener (Kenneth Gibson): Good morning and welcome to the 27th meeting in 2014 of the Scottish Parliament's Finance Committee. I ask everyone present to turn off any mobile phones or other electronic devices, please.

We have received apologies from Malcolm Chisholm and Jean Urquhart, so there will be only five members of the committee today. That will allow a lot more flexibility for members to ask questions of our distinguished guests.

Our first item of business is to take evidence on further fiscal devolution from Professor David Heald from the University of Aberdeen, Professor John Kay from the London School of Economics and Professor Ronald MacDonald from the University of Glasgow. I have been informed that Professor Kay needs to catch a train from Waverley at 11.28, so we will aim to conclude the session by around 11.00, to allow him to get to the station on time.

Professor John Kay (London School of Economics): Thank you.

The Convener: We have received written submissions from each of our witnesses, so we will go straight to questions. I will start, but not in an obvious place—I will start somewhere a wee bit unexpected. You all have divergent views on this issue, so it will get a wee bit of interaction going.

Professor MacDonald, on page 3 of your paper you say:

> "The remaining smaller taxes that I would recommend devolving are: air passenger duty, capital gains tax and inheritance tax."

For the record, will you explain why you support devolution of those taxes? After that, I would like your colleagues to give their views on that, if they so wish.

Professor Ronald MacDonald (University of Glasgow): In broad terms, in the piece that I wrote, I was trying to address vertical fiscal imbalance, which is a big issue and which has been a big issue for the Scottish Government and the Scottish Parliament since their inception. My main focus is on the bigger taxes—income tax, VAT and so on—which I am sure we will come back to later. As you will see, I have a table in which I try to apportion different amounts from the taxes. The bigger taxes are straightforward. You focused on the smaller ones.

There has been a big discussion about the environment in Scotland—the Greens are particularly interested in those issues—so it is natural that control of air passenger duty would or could be devolved.

Inheritance tax and capital gains tax are rather small taxes, so I am not going to go to the stake on them, as it were. Basically, I am saying that I do not have any issue with devolving those taxes. If you look at the evidence in Switzerland, which has devolution of those kinds of taxes within the cantons, you see that that has not created any particular issues for the overall federal structure. I do not see a particular problem with devolving those taxes to the Scottish Parliament.

Professor David Heald (University of Aberdeen): I would make two points about the smaller taxes. One has to be very careful about devolving taxes that people only want to reduce or abolish, because that will not resolve funding issues, and smaller taxes introduce questions of volatility, because it is more difficult to work out what the block grant deduction would be.

Capital gains tax probably fits alongside income tax. What one does about income tax might well affect what one decides about capital gains tax. There are considerable opportunities for people to convert income into capital gains, which is one reason why those taxes sit beside each other.

I suspect that you would probably get a race to the bottom with inheritance tax, with people trying to attract high-income, high-wealth taxpayers into their jurisdiction.

Professor Kay: I agree with Professor Heald—I am sure that we will come back to this point—that there is a danger in devolving taxes simply because people wish that they could be lower; it is not going to be the case that all, or perhaps very many, taxes can be lower. However, with that caveat, devolving air passenger duty seems to me unproblematic. However, devolving inheritance tax and capital gains tax seems to me another matter altogether. For inheritance tax, if there are material differences, we would have to think hard about the implications of residence rules and people taking advantage of them. For capital gains tax, that problem seems to me to arise in spades.

Devolving income tax on savings is a different ball game from devolving income tax on earnings. However, if one wanted to devolve income tax on savings, one would start to think about devolving capital gains tax. Again, though, we get into issues of what are Scottish assets and what are Scottish residents, and we get into the interaction between capital gains tax in Scotland and capital gains tax in England. In quite a lot of cases, if there are material differences, capital gains tax is probably a can of worms that one would prefer not to open.

The Convener: Okay. Thank you. Obviously, the biggie is income tax. Professor MacDonald, you said in your written submission:

"I have sympathy for proposals that involve the full devolution of income tax."

Professor Kay, you said in your submission:

"Obviously it would make sense initially to take over the existing UK income tax code in its entirety, but over time this could be changed."

However, Professor Heald, you seem to have a lot more caveats about devolving income tax. Can you tell us what your concerns are about the full devolution of income tax and where you think the boundary should go? I realise that you talked about that in your submission, but I am keen to hear your views directly for the record. I invite Professor Kay and Professor MacDonald to comment, too, if they wish.

Professor Heald: Much depends on what people mean by full devolution of income tax. In the political parties' submissions to the Smith commission, the differences in substance are not actually as big as the rhetorical differences. If you mean by the full devolution of income tax that you start again and have a completely different Scottish income tax system from the United Kingdom system, that is quite different from Scotland deciding on the rate bands and the thresholds.

I was at a conference last week that was organised by the UK Public Accounts Committee at which I was told that the UK tax system had 1,140 reliefs and allowances, so there is massive complexity in the income tax system. To go back a long time, I proposed in 1976 what became the tartan tax. I think that the reason why that was not used is that, when there was a chance to use it, the Scottish Parliament had too much money because of increases in health and education expenditure in England, and because politicians were warned that, if the tax was used in the downwards direction, the Treasury would exploit the lack of transparency of the block grant to punish Scotland indirectly.

The Convener: That is right.

Professor Heald: I can understand that politically after the referendum there is a window of opportunity in which there might be substantial devolution of tax powers that would otherwise have been difficult to get or would have been got in the very long term. However, one has to think carefully about the capacity to run a Scottish income tax and exactly what is meant by it. For example, does the definition of income remain the same? Does the personal allowance remain the same? What happens to tax bands and tax rates?

One of the points that I make in my paper is that, to some extent, because of the switch between direct tax and VAT and the increases in the personal allowance for income tax, one is increasing the concentration of income tax revenues from a small proportion of income tax payers. The numbers that I quote in my submission show that 42,000 Scottish income tax payers pay 22 per cent of Scottish income tax. There is a concentration on a very small number of people.

Clearly, both the actual behavioural response to differentials between Scotland and England and the expectations of differentials could have significant effect. In the past, it has not mattered whether one had a Scottish residence or not. Under the tartan tax, the difference it could make whether one was or was not a Scottish resident was capped, because the tax applied only to the basic rate. Under the Calman tax, the potential cost for a very high-income person is much higher. If Scottish income tax were to be completely separate—by that I mean the definition of income and so on—there could be significant issues about residence and mobility of population. That would include people pretending to move when they have not, such as people who have residences in Scotland and England.

The Convener: How does it work in Europe, where there is a vast array of tax jurisdictions? Germany, Holland, Belgium and Luxembourg are all within an hour's drive of each other. Surely there are systems that have been developed over time by many other countries.

Professor Heald: There is a psychological issue in the UK, which, for example, does not apply in the US. Distance is a factor. The last time that I checked, 23 US states had income tax powers and the others did not. Psychologically, partly because of the domination of UK politics by Westminster and the centralisation of the UK media, we can imagine the kind of difficulty there would be politically with even small differences in income tax.

The more general point that I would make on tax devolution is that you have to be careful that you do not take on lots of fiscal risks without having policy control. It is all right to say that the Scottish Parliament should be funded by its own revenues, but the crucial question is whether one means genuinely devolved taxes, where the Parliament controls the tax base and the rate, or whether one means an assignment of revenues. Professor Kay describes such assignment as "cosmetic".

Within the United Kingdom, how much fiscal risk do you want to take on when you do not have the policy levers? For independent countries such as the Netherlands and Belgium—or Scotland if it had voted yes in the referendum—it is a different ball game. However, in the context of the United Kingdom, when Scotland does not have control over monetary policy or the stance on fiscal policy, I hesitate about how much fiscal risk one should take on.

The Convener: What is your view on control of rates, bands and thresholds?

Professor Heald: The big issue will be the definitions of income and personal allowance. Scotland has congratulated itself on the maturity of its referendum campaign, but I found the debate incredibly depressing, because people seemed to think that getting tax powers would mean that Scotland could spend more. Within the context of the UK and Scottish fiscal position, and with what the former head of the International Monetary Fund fiscal affairs department Vito Tanzi called "fiscal termites", Governments are going to find it very difficult to maintain their tax base.

My worry about too much devolution of income tax would be that one would get lots of arbitrage. Differences would be exploited in a way that would force down tax revenues. If one wants to protect the tax base, one has to be careful.

One only has to look at what is happening with corporation tax. At the Public Accounts Committee conference last week, one speaker predicted the demise of corporation tax within 10 years. That is probably fanciful, but it is not impossible, considering the downward movement of rates and the fact that, even though the UK subscribes to the Organisation for Economic Co-operation and Development's base erosion and profit shifting project, it is using the patent box.

There is a downward pressure on tax rates. If you want a smaller state, that is a good thing. If you do not want a smaller state, you should be very careful.

09:45

Professor Kay: There are a couple of important points. One is—as Professor Heald has, in effect, said—that with increasing mobility of labour, capital and economic activity more generally, and with the growth of activities to which it is difficult to attach a place, the ease of collecting tax is being undermined. Corporation tax is the worst example of that problem, but it arises for a number of other taxes as well. Those are not insuperable problems, either currently or in the foreseeable future. If we want to run wildly different taxes in Scotland, people will make the systems work in the end.

There is a difference, however, between the situation that we would face in Scotland under independence—in which we would just have to sit down and make those things work, and work out Scottish solutions to the problems—and the situation that we face with devolution in the unitary state, in which we have to ask the question: are the additional levers that we would get from things that are going to be very complicated actually worth the bother of getting?

As far as income tax is concerned, it seems to me that what is likely to emerge from the Smith commission discussions is that Scotland will be given control over the rates while banding will be left pretty much as it is. That would give Scotland a lot of freedom to determine additional revenue from income tax, if it wanted to.

When one starts to ask whether we in Scotland want to take on responsibility for the detail of the tax structure, one then has to ask whether there are advantages to doing so that offset the very considerable administrative problems and the negotiating issues that would have to be resolved vis-à-vis England in particular, but also other countries. It is not obvious to me what the balance of that advantage is.

Professor MacDonald: As I say in my submission, I come at the issue as a macroeconomist rather than someone who looks at the microeconomics of tax rates.

To summarise Professor Heald's position, which is on an issue at the heart of the debate, the question is whether we try to retain stability of revenue through continuing with a block grant providing the main revenue for the Scottish Parliament, or whether the Scottish Parliament is prepared to accept more risk. As Professor Heald said, if we have control over tax thresholds, we could end up, for example, punishing those who pay higher marginal tax rates. Labour mobility is very high within the UK so, as Professor Heald's argument implies, in such a scenario those people would move south of the border. Of course, the main disciplining effect of devolving taxes is that the Government knows that that can happen, so presumably it will take that possibility into account when making its decisions. Therefore, I would not rule out further devolution of taxes simply because labour and capital are mobile.

I would come at the issue from a different perspective. To pick up on what Professor Heald said about the referendum, I think that there is a fundamental misconception among the polity and the electorate about what fiscal autonomy means. People think that, if Scotland gets more fiscal autonomy—devo max, or more revenue devolved—it automatically means more spending. Of course it does not; it means much more risk. The kernel of the problem is how to handle that risk. As I wrote in my submission, I am keen for the Scottish Government to handle the risk in as optimal a way as possible while recognising that, as part of the UK, we have very clearly voted for a social protection mechanism that is based on resource pooling and risk sharing.

Those are the kinds of balances that I would like to see. I hope that that sheds light on what I have said in my submission.

The Convener: Thank you. We are nearly 20 minutes in and I have not let my colleagues in yet. Before I do so, I am just going to ask one further question.

You talked a wee bit about not having the opportunity to spend more through the various taxation routes and the high risks involved in that. The Scottish Futures Trust, which will give evidence under the next agenda item, has suggested borrowing as a possibility. Its submission to the Smith commission states:

> "Scotland should have the power to be able to determine the right level of infrastructure investment to affordably meet its economic and social objectives, and how this investment is both funded and financed."

Basically, it suggests that constraints on borrowing powers be removed entirely, pointing out that local authorities do not have the same restrictions as the Scottish Parliament has. It states:

> "It appears inequitable that Scottish Government should have a cash value borrowing limit imposed as a reserved matter, whereas local authorities are essentially self-controlling under a codification of ability to repay."

It believes that what it suggests would allow the Scottish Government considerable freedom in how it invests in infrastructure, enhancing Scotland's asset base and creating jobs along the way. I ask each of you to comment on that and to give your views on the issue.

Professor Kay: I begin by emphasising what both Professor MacDonald and Professor Heald said about the widespread idea that fiscal devolution means that Scotland has more money. It does not mean that. There is a great deal of discussion about people wanting more powers in Scotland, when what they really want is more money for the powers that Scotland, in large part, already has. To be blunt, that money does not come either from a block grant or from taxes. That is an issue in relation to additional infrastructure spending.

Borrowing powers for Scotland would appear in the first instance to be a way of giving the Scottish Government more money. Indeed, that is in large part the way in which borrowing has been discussed over the past few years. Scotland ought to have more borrowing powers, but it ought to implement them rather carefully and slowly, and in the present situation, given the level of the UK national debt, it should probably not implement them at all.

We should be careful about saying that there would be benefits from infrastructure spending. We need a lot more infrastructure spending in Scotland and the UK, but it needs to be well targeted. We are sitting in Edinburgh, where we can watch going along Princes Street every day what must be one of the worst infrastructure projects in the history of the world in terms of the capacity for useful infrastructure and revenue generation that it provides.

The Convener: Okay. I will not touch on which political parties supported that and which opposed it, but I think you are aware of that.

Professor Kay: I have no idea, actually. [*Laughter*.]

The Convener: Professor MacDonald, do you want to comment on the borrowing issue?

Professor MacDonald: Yes. I echo what Professor Kay said about the infrastructure issues. He is absolutely right about that.

As I say in my submission, if you are going to say to the Scottish Parliament, "You have to take on more fiscal risk if we're going to devolve more powers," you have to allow it to borrow. That fits in with my notion of the hard budget constraint.

If this is to work, it cannot just be about taxing at the margins. You have to move away from being what I and others have called a pocket-money Parliament—sorry—to being a Parliament that raises a substantial amount of revenue itself, and if it does that, it will face risks. If there is a recession, it will not have the same risk pooling and risk sharing that it would have if it did not have devolved or assigned revenue, and it will therefore have to have some way of making it up.

I argue that the Scottish Parliament should be allowed to borrow for that reason as well, and it should borrow on the open market, because that is the only clean and effective way to bring market discipline and be consistent with the hard budget constraint.

There are ways of doing that through the Treasury, but that would bring in all manner of stability pacts and so on, which I do not think are as clean as simply allowing the Scottish Parliament to borrow on the marketplace. The market will ultimately discipline the Scottish Government's borrowing, so we should get an optimal outcome in that sense.

Professor Heald: I will pick up on something that Professor MacDonald said. I get worried when people start talking about 54 per cent of the Scottish Parliament's budget being funded by its own revenue without making it clear that a lot of that revenue is outside policy control.

I do not really accept the way in which Professor MacDonald uses the idea of the hard budget constraint if we are talking about revenue that you do not control. On assigned VAT revenues, for example, Scotland might get either a VAT revenue bonus or the opposite, depending on UK Government decisions.

We should return to the question whether we should consider the capacity to raise revenue at the margin, or the average percentage of your spending that you finance.

I agree with what has been said about borrowing. If you have more tax responsibilities, you require more borrowing power simply for smoothing purposes.

On the question of infrastructure spending, for quite a long time I have made a good academic living out of public-private partnerships. I am worried that, because fiscal control will be very tight, there will be a moving on from public-private partnerships to guarantees. One sees that in the United Kingdom in the context of Hinkley Point C power station: the UK Government is effectively, but not transparently, contracting to take the output for the lifetime of the project.

There is a question around borrowing for capital purposes and borrowing for revenue smoothing purposes. There is also an issue about the constraints that are imposed by membership of the European Union—while the UK remains part of the European Union—simply because the UK Government has overall responsibility for UK public borrowing.

Professor Kay: I have two points to add. The first is that, realistically, the UK Treasury is not going to allow the Scottish Government what would be substantive borrowing powers. There are red lines as far as such things are concerned, and I am pretty confident that that is one of them.

The second point also relates to the UK Treasury, and has been referred to by Professor Heald: the amount of off-balance-sheet financing of various kinds that has been engaged in and is increasingly being engaged in so as to pretend that the Government is not borrowing as much money as it is. We have been doing that in Scotland, too. I am very keen that, if and when we have a beefed-up fiscal commission in Scotland, a large part of its responsibility should be to police that activity, so that we do not land future generations with liabilities that we have taken off balance sheet and shoved under the carpet for a period of years.

Professor MacDonald: I will pick up on the important issue of hard budget constraint relative to taxing at the margin. I will give you an example. If the Scottish Parliament were responsible for 90 per cent of its revenue generation—even if that comes from assigned taxes and the Scottish Parliament knows that the revenue that it obtains in the next period will be conditional on how it spends its funding—that will give you a very different outcome, and a more accountable one, in my view, compared with a situation where the Parliament has to raise only 2 per cent of its funding, with the rest coming from the block grant, so that it relies on the block grant to fund its spending over the next period.

Those are two very different scenarios and, even if you are assigning taxes without having control over the tax in terms of devolution, the magnitude of the budget that is actually devolved, in some sense, to the Parliament still makes a big difference.

10:00

Michael McMahon (Uddingston and Bellshill) (Lab): I will use Professor MacDonald's submission to get me into an area in which I have a particular interest. My question relates to the continuation of the block grant in terms of what you call the "social protection system". Northern Ireland currently has a devolved welfare system, but it has maintained parity with the rest of the UK. Is what you describe similar to what happens in Northern Ireland? Alternatively, are you concerned about the relationship as it currently exists between the devolved welfare system in Northern Ireland and the system in the rest of the UK?

Professor MacDonald: To be candid, I have not really focused on the situation in Northern Ireland. My point is that if you go for a purely fiscal autonomy-type set-up, you are not engaged in what I refer to as

"risk sharing and revenue pooling."

I believe that the outcome of the referendum was that people want to be part of that risk sharing and revenue pooling mechanism and that that is largely because they want what I call the social protection—or welfare—budget to be at the centre. Of course, that issue is open for discussion, and I discuss it in my submission in terms of some marginal changes to the welfare budget spend.

As I see it at the moment, rather than focusing on whether to devolve more powers on the spend side, we really have to focus on getting the existing fiscal gap into shape before we start talking about yet further spending devolution to the Scottish Parliament. That is where I am coming from as a macroeconomist. As I say in my submission, and as everyone concedes, the Scottish Parliament already has a significant chunk of the spending—depending on how you define it, it is between 50 and 60 per cent—but very little in the way of compensating tax revenues. That means that the Government is not properly accountable. The question is how we address that.

I would answer your question by saying that I would rather focus more on the revenue side until we get that balance right before we think about more major spending devolution.

Michael McMahon: Thank you—that is helpful.

Professor Kay also touches on the issue. You raise the question of whether it is possible to "'unpick' the benefit system". You also mention the arguments for having a connection between income tax and benefits policy. Can you expand a bit on what you mean by the dangers of unpicking the system?

Professor Kay: There are two issues. First, you have described the situation in Northern Ireland in relation to benefits, where there is power to change things but in fact nothing has changed. There is what I think is a devolution paradox, particularly given that the UK has traditionally been a rather centralised state. As politicians, you will find that your constituents will allow you to make things better than in the rest of the UK, but they will not allow you to make anything worse. The only thing that you can do in a budget constraint situation is leave things unchanged, so we get the situation that you described in Northern Ireland and which we have had in Scotland in relation to the tartan tax: you have the power to change things but you do not use it.

The second question is the one that I raised about whether we can unpick the benefits system. Can we find parts of the benefits system that we can devolve to Scotland in meaningful ways that would give it the power and possibly the desire to change them, without devolving everything to do with the benefits system? To my mind, the desirability of having an integrated benefits system—and, indeed, a benefits system that not only integrates all benefits but is integrated with other parts of social policy and which also takes account of the structure of income tax—means that it is quite difficult to satisfactorily unpick bits of such a package. I therefore tend towards the view that in the current situation you really are faced with a choice of all or nothing: you either want to devolve everything or you do not want to devolve very much.

Michael McMahon: Professor Heald, do you want to comment?

Professor Heald: I want to pick up on a couple of points. Northern Ireland has, essentially, administrative control of the social security system. The UK funding depends on Northern Ireland following UK policy, and there is currently a major political argument in Northern Ireland about the so-called bedroom tax, which has not been implemented there, so there are arguments between the Northern Ireland Executive and the Treasury about that. You have to be careful about language. In practice, there is no devolution, because the willingness of the UK Exchequer to fund benefits in Northern Ireland depends on Northern Ireland doing basically the same things.

The situation in Northern Ireland raises another issue. If you want to devolve income tax, you can forget about tax base equalisation because Scotland is sufficiently close to the UK average on almost everything. You cannot do that in Wales or Northern Ireland, because they are much poorer than Scotland and England. If you want the outcome of the process to be a stable new devolution settlement, you have to think about how the changes might in future affect Northern Ireland and Wales. Although it would be easy to go ahead with income tax devolution by saying that Scotland is sufficiently average that we will not get involved in that kind of complication, we still have to think about it because of the possible extension to Northern Ireland and Wales, which should at least have the chance to decide whether they want to go that way.

I agree with much that Professor Kay said about the question of the benefits system as a whole and the relationship between tax and benefits. UK policy over the past 25 years has gone very much in the direction of the integration of taxes and benefits. Where there seem to be policy benefits in the devolution of welfare—for example, housing benefit—you come up against the problem that the Scottish Government has set out in its submission to the Smith commission, which is that housing benefit will be rolled up into universal credit. That is an area that we have to think about carefully.

Michael McMahon: My follow-up question is for any of the witnesses who want to answer it. You have all mentioned the fact that there is a perception that devolution means more spending in certain areas. The idea that devolving benefits would therefore follow that logic suggests that benefits would be increased in Scotland. Is that your reading of the argument? What concerns do you have about benefit tourism, as it is called? If we were to have differentials between Scotland and the rest of the UK, what is the likelihood of there being benefit tourism?

Professor Heald: You are taking me outside my comfort zone. I want to answer that question in a particular way. There is a view at the UK level that certain cash benefits should be the same across the UK. We all know that, if you live in London, an old-age pension does not buy you as many goods and services as it would in the north of England, but we stick to the idea of equal cash payments.

One of the problems with devolving welfare is that people would expect benefits to go up, which immediately raises the question of how that would be financed and what would be cut. You could argue, as people have argued in Northern Ireland, that there is a case for lower benefits, because wages are generally lower in the Northern Ireland economy, but you can see the political difficulty that that would involve.

People have two quite different attitudes: they want local, regional, national and sub-national choice, but they immediately raise the question of the postcode lottery the minute you actually suggest that. To some extent, the UK settled on a position in which you can devolve service provision in areas such as health and education without varying the level of cash benefits.

I do not see any advantage in devolving cash benefits unless you are willing to accept that they may vary. My concern is that the expectation will be that they will become more generous.

Professor MacDonald: My general principle, which I try to put across in my submission, is that further devolution of powers to the sub-central Government—the Scottish Parliament in this case—is better able to reflect the preferences of the electorate in Scotland. I gave the example that in Scotland we have had a different policy on the elderly, so perhaps there is a case for devolving attendance allowance to the Scottish Parliament.

On Michael McMahon's example, I agree with David Heald's point. If you are talking about actual benefit payments, you will run into the same problem that you will run into with the tax side of things: if you tax differently you will get mobility, and in a similar sense you could get benefit tourism.

Some benefits policies are not related to labour mobility, such as the bedroom tax. Scottish policy on that may reflect different preferences and there may be a case for devolving benefits that are not specifically related to people's mobility.

Professor Kay: I cannot foresee a world in which Scotland has enough money to pay benefits at levels sufficiently superior to levels in England for benefit tourism to be a problem. It goes back to the issue that underlies all of this: the tendency to think that devolution of powers means more money to spend on those powers. It does not.

Jamie Hepburn (Cumbernauld and Kilsyth) (SNP): I have a question related to Barnett, but given the exchange that we have just had, I was wondering how much evidence there is, beyond what is in some of the right-wing newspapers, for such a thing as benefit tourism?

Professor Heald: As I said a few minutes ago, you have taken me outside my comfort zone. You would have to ask a social policy expert about that.

Professor Kay: The answer is "not very much", but one must make the observation that it is a lot easier for someone from England to move to Scotland and feel comfortable here than it is for an unemployed person from Romania to move to England or Scotland and feel comfortable.

Jamie Hepburn: We know from the Scottish Government's submission to the Smith commission that its starting point is that the Parliament should raise all of its revenue and make payments to Westminster for reserved services, but we also know that the Smith commission is working on the basis of consensus, so we do not know where the process will end. If Scottish Government's position is not reached, I presume that there will still be allocation of resources, in which case the Barnett formula will come into play.

Professor Heald, you say in your paper:

"'The Vow'"—

then in the best academic tradition you list the authors—

"(Cameron et al, 2014) on the front page of the Daily Record on Tuesday 16th September included the three leaders' commitment to 'the continuation of the Barnett allocation of resources'. Although this sounds definitive, the actual meaning is ambiguous."

Professor Kay, you say:

"whatever commitments may appear to have been made in the last days of the referendum campaign, the Barnett Formula is now inevitably under pressure."

Will you talk about the vow's ambiguity, which Professor Heald speaks of, and the pressure that you speak of, Professor Kay?

Professor Kay: The ambiguity is that, operated literally, since 1978 the Barnett formula ought to have produced substantial convergence between public spending levels in Scotland and those in the UK as a whole. It has not done so, which is a measure of the discretion that the UK Treasury has exercised, in what have not been well-articulated ways, to be relatively generous to Scotland in that settlement.

After what has happened this year we have to face the fact that the Barnett formula, which previously was understood by only a few politicians and academics—indeed only a few politicians and academics had even heard of it—is very much on the political agenda. It is quite difficult to find an objective justification for what Scotland receives and the Barnett formula's generosity. Whether or not the Barnett formula survives in a formal sense, we in Scotland must acknowledge that it will come under pressure and generate resistance and resentment in a way that it has not done in the past.

10:15

Professor Heald: I discussed the issues with the committee in June. I disagree with Professor Kay on one point. The reason why there has not been convergence has been less to do with Treasury generosity to Scotland and more to do with relative population change. The numbers that I want are not in the public domain and probably no longer exist in the Treasury, but the point is that the convergence has been largely offset by Scotland's falling relative population. Jim and Margaret Cuthbert have made the point several times, particularly in the 2000s. If Scotland's relative population had not been falling, I think that there would have been convergence.

An attraction of Barnett is its population adjustment mechanism. We have had such a mechanism for most of the time since the 1880s. An advantage of a population adjustment mechanism over a detailed needs assessment is that—leaving aside whether Scotland is overfunded or underfunded—a needs assessment involves working out how much Scotland needs to spend on health, education, social services and so on, and it becomes very much more difficult to maintain the block nature of the system.

What I would like to have—after the vow—is a serious discussion about the population adjustment mechanism versus a regular needs assessment. An obvious international example of how to do a needs assessment is the work of the Commonwealth Grants Commission in Australia. People underestimate two difficulties with a needs assessment: first, how big an exercise it will be if it is done properly; and secondly, the toxic political climate in which it will be done. There are plenty of exercises around—such as the Holtham commission exercise, which said that the Scottish block grant should be cut by £4 billion—which will automatically produce the allegation that people have decided the result before the exercise starts.

To my mind, the question about Barnett is the lack of attention that was paid to it under the Labour Government. In 2002, Alasdair McLeod and I published proposals for the Institute for Public Policy Research, on what we had to do to Barnett if we were to deal, in particular, with the problem of Wales. Nothing happened. That was partly because so much money was coming through the formula that the issue was receiving no political attention.

It is clear that the resentment against Scotland is going to grow. For example, Scotland gets blamed for the way in which the English distribution formula treats the north-east of England badly. Barnett gets blamed for all sorts of things that are nothing to do with Barnett, but we need a debate about how the block grant works. I disagree with prominent public figures who have said that Barnett does not matter because the block grant will be smaller; it matters crucially, because while the UK Government has most of the major revenue sources it affects how much public spending the UK Government is willing to underwrite in Scotland.

Jamie Hepburn: When you talk about ambiguity, are you saying that there could be enough leeway for the UK Government to come up with a new system that still has the "Barnett formula" tag and thereby keep to the vow?

Professor Heald: It has certainly changed the language debate. I thought that the Barnett name would go and something similar would remain in place, but we might now be in the position that the name stays but the substance is different.

I would want to interpret the vow as meaning that the population adjustment system would remain but with periodic needs assessments. I had always expected that in due course there would be a needs assessment but without Scotland being treated as a region within the context of an English needs assessment of health and local government.

The question is this: is Barnett a system whereby the Treasury cannot get its hands on particular programmes in Scotland, Northern Ireland or Wales that it does not like, or does it mean more favourable public expenditure treatment for Scotland? I suspect that, if I was a regular reader of the *Daily Record*, I would take the vow to mean that Scottish public spending was being protected. However, is the mechanism itself being protected—and I should say that I think that the mechanism has been overcriticised, partly because the Labour Government did not properly maintain it and just ignored it while there was plenty of money around—or is Scotland going to keep its expenditure advantage over much of England?

Jamie Hepburn: We have already talked a little about the assignment of VAT, and we know that under European Union jurisdiction the setting of VAT cannot be devolved. Professor Kay and Professor Heald both mention the assignment of VAT in their submissions; indeed, Professor Heald has already referred to Professor Kay's description of the move as "a cosmetic change".

Three questions follow from that. The first and fundamental one is whether VAT should be assigned. Secondly, does the Scottish Parliament have the requisite levers just now or should it get other levers to influence the revenue accrued through VAT? Thirdly, although Westminster would presumably be responsible for setting the rate, should the Scottish Parliament, in the event of VAT being assigned, have some statutory role in at least being consulted on what the level should be?

Professor Heald: I am not dogmatically against all tax assignment; what I do not like is assigned revenues being represented as your own taxes.

The most obvious case of assignment working is in Germany, but it works there because of the Bundesrat’s powers to negotiate with the Federal Government. Because of the political momentum demanding that something big must happen, I would not be surprised to see partial assignment of VAT revenues, but the policy levers will clearly remain with the UK Government. I was recently looking at the “Northern Ireland Net Fiscal Balance Report”, and I noticed that VAT has become a bigger source of revenue than income tax. On the basis of the present direction of travel, we might in a few years’ time see the same thing in the “Government Expenditure and Revenue Scotland” numbers.

What would happen is that the Scottish Government and the Scottish Parliament would start to argue with the UK Government and the UK Treasury over VAT. Compared with most European countries, the VAT base in the UK is very narrow—I think that about 55 per cent of consumer expenditure is on things that come within VAT—and that contributes to the problem of a VAT tax gap. Indeed, the Mirrlees committee recommended that the tax base be broadened. However, that would be extremely politically difficult at any time, and I think that it would be even more politically difficult in the context of austerity.

One of the consequences of assigning VAT revenues is that you and the Scottish Government will want to have a say in UK VAT policy. The question is whether the UK Government is willing to concede that.

The issue comes back to the problem of the UK being asymmetric. In the context of the symmetric federalism of Germany, it is a lot easier to see where the levers for consultation and participation are. It is much more difficult in the UK.

Professor Kay: I cannot honestly see the Scottish Government arguing with the UK Government that VAT ought to be imposed on food and children’s clothing, even though I agree with Professor Heald and most people who have examined the VAT base in the UK fairly objectively, like Mirrlees, that it is narrower than it should be for an efficient overall system of taxation. Scotland might want to argue for some kind of say, but I do not think that it would actually want to have it or to say such things even if it were able to do so.

Jamie Hepburn: Professor MacDonald, I do not mean to neglect you. I know that you have said something about VAT assignment, so, if you want to say anything on the matter, go on.

Professor MacDonald: Only to confirm that, as you said, VAT is a reserved tax, so we cannot devolve it. Therefore, the only way that we can do anything about it is by an assignation. As I said in my submission, I propose that a significant chunk of VAT—about 50 per cent—should be assigned to the Scottish Parliament.

Jamie Hepburn: Professor Heald, you say in your submission:

> “If the UK Treasury does not have a financial stake in the Scottish income tax base, I would expect both malicious actions … and malign neglect”.

Will you say what you mean by that? To give a specific example, do we already see a degree of neglect—malign might be too harsh—in the process for the block grant adjustment arising out of the taxes that have been devolved? The UK Treasury has still not given any clear indication how the block grant will be adjusted in relation to those taxes.

Professor Heald: My adjectives were chosen to attract attention to the issue. One of the things that we have to think about is that we cannot change the system of the government of Scotland within the United Kingdom without thinking about the UK.

I spent 21 years as a specialist adviser to the Treasury Committee of the House of Commons and, at the end of those 21 years, became more and more depressed about the way that the UK runs its public finances. Budget day is a completely artificial occasion whereby the chancellor has to find some rabbit to pull out the hat to catch the Opposition off guard, and the things that catch people off guard are sometimes the ones that go spectacularly wrong in the longer term. One that I remember is Gordon Brown’s zero starter rate of corporation tax, which encouraged a lot of dubious incorporations.

If one is going to get a stable system working in which Scotland has significant policy control over income tax, the UK Government will have to bring its budget forward from March or April to November and engage the UK Parliament much more seriously in discussions about the budget. Basically, the Treasury Committee of the House of Commons does not fulfil its role as a tax and spend committee. It is heavily involved in other worthy things but does not act as a budget committee.

Under Calman, the Scottish Government has to notify by 30 November what the Scottish rate of income tax will be. In March or April, the UK Government can change rates and tax bands and control how much money will be brought in by the decisions that the Scottish Parliament took earlier. Therefore, one has to make sure that there is a basis for co-ordination of income tax. It is crucial that, once the Scottish Parliament gets beyond Calman-type income tax powers, there is some mechanism for co-ordination between the UK level and the Scottish level. As with broader issues such as monetary policy and control of the Bank of England, it is not obvious to me that the UK Government has even thought these things through.

10:30

The point about malign neglect relates to the question about resourcing of HM Revenue and Customs in the context of residence. Professor Kay made the point that residence matters, and it is fundamentally more important once income tax starts to be devolved than it was before. Previously, whether somebody was a Scottish income tax payer or other UK income tax payer might have been important in certain statistical analyses but it did not affect what tax people paid. One has to be careful to ensure that the Treasury-controlled HMRC puts enough resources into making sure that people's residence decisions are truthfully declared.

I emphasised earlier that, with 42,000 people contributing a large or at least significant proportion of Scottish income tax revenues, that tax base is at risk. The UK Government could, if it wanted, attract tax payers by making changes in UK income tax.

Jamie Hepburn: You talked of the need for investment in HMRC, but the trend over a long period of time from the UK Government seems to have been disinvestment from HMRC. You said that you are not confident that it is thinking these things through. It is a pretty gloomy outlook that you have there, is it not?

Professor Heald: HMRC is going through a technological revolution in the way in which the tax system works, in terms of its IT systems. It is easy to criticise people from outside for getting it wrong. We can see why HMRC's labour force will change as the nature of its operating systems change. However, if you are asking me whether the UK puts enough money into tax enforcement, the answer is no.

Jamie Hepburn: Thank you.

Gavin Brown (Lothian) (Con): My first question is a narrow one for Professor Heald. You commented that VAT is a bigger deal than income tax in Northern Ireland. Is there a specific reason for that?

Professor Heald: Over the past 20 years, the trend for the basic rate revenue has been downwards as income tax thresholds have gone up significantly, and VAT rates have gone up.

The situation is one of the accidental consequences of UK decisions. Nobody sat in London saying, "We'll change the composition of Northern Ireland tax revenue," but Northern Ireland is a fairly low-wage economy, so putting the threshold up will have a big effect and will change the balance of taxation between income tax and VAT.

There was no Northern Ireland content to the policy. It is just a manifestation of what happens with a relatively low-income economy and a much higher threshold.

Professor Kay: There is a Northern Ireland content in the sense that Northern Ireland is a low-wage economy in a way that Scotland is not.

Gavin Brown: That is helpful. Thank you.

My second question is about something that we have not touched on so far but which you all comment on in your submissions—corporation tax. I would like each of you to expand on why you reached the views that you did in your submissions about the devolution or non-devolution of corporation tax, with specific reference to the legality issue. I have not encountered that issue much in discussion of the topic, but a couple of you mention it specifically. I am keen, for the record, for you to expand on your views on corporation tax.

Professor Kay: My understanding is that, in general, the EU prevents us from having differential rates of corporation tax within a member state without a special justification, which is quite hard to construct in the case of Scotland.

On the question whether we would want to have differential rates, I think that, if we could, we probably would want to do that. In effect, because of my point about the mobility of things in the present world, you can attract not just economic activity, but the appearance of economic activity for the purposes of your tax base by having a significantly lower rate. That is why Scotland, as the smaller part of the union, might want to do that; it is also why England, as the larger part of the union, would want to prevent Scotland from doing that.

Indeed, I think that that would be the outcome of the discussion, so I do not think that the devolution of corporation tax is going to be on the agenda except, perhaps conceivably, to a small degree—but, for those reasons, the small degree is not worth doing.

Professor MacDonald: I said in my submission that—basically for the same reasons that

Professor Kay has given—the tax should not be devolved.

First, on European legislation, we know that in the past Ireland had much lower corporation tax, but that loophole is going to be closed and there will not be the same scope in Europe to do what Ireland did.

I was initially attracted to devolution of some taxes, such as corporation tax, for reasons of tax competition. That seems to work rather well at the margin in some federal countries, such as Canada, but, as Professor Kay said, given the UK's asymmetric nature I doubt that it would work here because we have a much bigger partner who would probably react.

The other point against devolution would be the level of corporation tax. If we had been talking about this topic 10 years ago when corporation tax was at a much higher level, perhaps there would have been more sympathy for competition, but now that it is down to about the 20 per cent mark it is harder to see how that would work.

In my submission, I have said that I do not see any issue with assigning corporation tax, but I would not see it being devolved.

Professor Heald: I will make a specific point related to Northern Ireland. In 2003, I wrote a paper for the Northern Ireland Economic Council when the discussion of devolved corporation tax for Northern Ireland was running strongly. The issue is still around and nothing ever happens.

There may have been a time in Northern Ireland's political history when the European Commission might have been willing to tolerate a lower rate of corporation tax, but an issue is that, if one part of the UK has a lower rate of corporation tax than the others, there will be both the genuine diversion of economic activity and the fake diversion of profits. Therefore, we can see clearly why the UK Government is reluctant.

The UK Government probably hides behind the European Union rules about the variation of corporation tax in a member state. I have read the Azores judgment and subsequent European Court of Justice judgments but, for a detailed answer on the issue, you would need to ask a lawyer.

The corporation tax stories that one hears about Amazon, Google and Starbucks are important in the sense not only that they are a source of revenue loss but that they create the impression among the electorate that certain companies and individuals are outside the tax rules. That is a significant threat. Indeed, one of my fears is the loss of legitimacy of the tax system. Given the difficulty that large states have in protecting their tax base, having differences in corporation tax between Scotland and the rest of the UK would lead to a lot of arbitrage by very clever lawyers.

I do not think that corporation tax devolution is on the agenda, and I would not be in favour of it if it was.

Gavin Brown: Thank you.

I know that you have all commented on this next issue, but I am keen, for the sake of the record and to allow you to expand on it, to hear your views on the devolution—or not—of national insurance. We will stick to the same format, but perhaps Professor MacDonald could go first this time.

Professor MacDonald: I have advocated that we could devolve a portion of national insurance. I think that it has always been thought that national insurance is geared towards the welfare state. Obviously, that was the original intention and that was how the tax originally panned out, but with the passage of time, it has become simply a tax on income and employers. In that context, if we believe that income is the key thing to tax in the devolution context, I do not see anything against devolving a portion of national insurance tax.

I suppose that the other question is whether the employers or employees would bear the burden. Perhaps whichever of the two components is believed to be more mobile would determine that. I certainly would not rule out devolution of national insurance.

Professor Kay: I have made the point that the devolution of benefits on the welfare side of things is probably largely an all-or-nothing area. As Professor MacDonald has said, national insurance contributions are traditionally, and to some degree formally, linked to benefit payments, but they need not be, either in whole or part. We could easily see national insurance being recast as an employment tax, in whole or part, that could be devolved. However, devolving an employment tax is not materially different from devolving income tax on earnings, so that would not, in substance, give the Scottish Government a power that it would not have as a result of devolution of income tax on earnings.

Professor Heald: Economists tend to regard national insurance as just a second income tax. Politicians find that they can promise not to increase the basic rate of income tax, but can put up national insurance.

There is also the contested issue of the extent to which employers' national insurance is paid for by employees. That needs urgent attention at UK level. Leaving aside the more general questions about the pooling of risks through social protection across the United Kingdom, that would get into an incredibly difficult policy area, but some of the inconsistencies—for example, in having different thresholds—are a consequence of politicians' perception that the electorate do not think of national insurance as income tax.

The UK is by no means the only country that does that. We see many international comparisons of headline rates of income tax, but they generally do not say what the social security taxes are. One thing that would stop an individual country wanting to re-label such taxes as income tax is that their doing so would make their income tax, relative to that of other countries, seem a lot higher.

Gavin Brown: Thank you.

My final question is for Professor MacDonald—certainly in the first instance. In his paper, he talks about the vertical fiscal imbalance; other witnesses in previous weeks have done so. I am trying to get a handle on that. Obviously, if a country became an entirely independent nation state, we would say that there was no vertical fiscal imbalance there. Is there a universally agreed point short of that at which every economist—or at least a good number of them—will say that there is no vertical fiscal imbalance? At what point on the scale is there an agreed definition that there is no longer a vertical fiscal imbalance?

Professor MacDonald: There is no magic number. Most people look at a simple scatter plot of the OECD experience, for example. If you do that, you will see a cluster and countries including Scotland as big outliers. It is really a question of moving somewhere into that cluster, but there is no magic point on the scale.

I did the calculations kind of on the back of the envelope. I should probably do them in a slightly different way, but I do not think that the VFI would ever come down to zero. All we can say at the moment is that Scotland is a big outlier among developed countries and countries that already have sub-central levels of devolution. We need to get tax and spend more aligned.

Gavin Brown: That is helpful.

10:45

Professor Heald: The issue comes back to a point that has already been raised. In OECD numbers about the proportion of subnational expenditure that is financed by subnational revenues, Germany gets a high score. However, that does not mean anything, because almost all taxes are determined by the federal Government, with the Länder having a significant influence through the Bundesrat—generally speaking, the federal Government cannot do things without support in the Bundesrat. The UK might be an outlier on those numbers but, crucially, the issue depends on how we view assignment rather than tax devolution, and whether there is some kind of policy control.

John Mason (Glasgow Shettleston) (SNP): Last week, Professor McLean said that the best taxes to devolve are those that are linked to land, because the land cannot move. He said that that would apply to buildings, land and oil. Those were top of his list, although possibly inheritance tax would be thrown in. None of you has argued for that, I think. Do you disagree with him?

Professor MacDonald: No, I do not disagree. It is a very good economic principle to tax assets that are not moveable. However, given that, as we have said, we need a real movement in the VFI, we have to start looking at taxes on moveable assets. That is where I would be looking at the moment, although I would not rule out taxing those other things.

John Mason: Are you saying that that should be done as well?

Professor MacDonald: Yes.

John Mason: Does either of the other gentlemen want to comment?

Professor Heald: The Scottish Government already has legislative control of council tax and business rates. Council tax has been frozen for seven years and there has not been a domestic revaluation since the original council tax banding of 1991. Clearly, the 1991 bandings are pretty irrelevant, given the change in property prices, although it is perhaps not so great in Scotland as in parts of England. There is an important question about the willingness to take the political flak and deal with the system maintenance issues of particular taxes. If we do not deal with those issues, those taxes will erode, at least in terms of their legitimacy. At the Public Accounts Committee conference that I mentioned earlier, there was talk about the effect on business rates of online retail. The Scottish Government has to be much more proactive about the taxes that it controls.

Professor Kay: I will just briefly underline what Professor Heald has said. We already have three taxes on land—council tax, business rates and stamp duty land tax—and on all of them we have pretty much already reached the limits of what is politically possible, so I do not think that there will be more money coming from there.

Professor Heald: I was not suggesting that there should be more money. One of the difficulties with council tax revaluation is that people think that the Government will just get more money out of it. However, my point is that the balance of what people pay has become illogical and indefensible, certainly in parts of England, because the valuation has not been revisited. Members of the Scottish Parliament may remember the report of the Burt committee on local government finance, which the then First Minister disowned on the day of publication. I am aware of how politically sensitive such things are, but if you do not maintain the system, you can expect a loss of legitimacy in it.

The other thing—

John Mason: I am sorry, but we are going on to maintaining the system. My point was about which taxes should be devolved. My question was whether the taxes should be linked to land, and we have probably covered that, if you will excuse me.

Another tax that is linked to land is oil revenue, because the oil cannot move. Professor MacDonald says on page 5 of his submission that the UK, in effect, smoothes things out. Could the same result be achieved by Scotland having an oil fund and, in effect, smoothing things out by saving up in the good years and using the money in the poorer years?

Professor MacDonald: Yes, potentially. However, as we discussed in the referendum debate, it would be some time before Scotland could do that. In the full fiscal autonomy model, it would be very difficult to do that in the near term. It is certainly possible in principle to do it, but it creates additional problems in thinking about the devolution of extra powers, because it introduces the importance of an asymmetric shock. If the geographic share of oil revenues were to be devolved, it would open up Scotland to much more in the way of asymmetric shocks. Therefore, the idea that macrostabilisation would come from the centre would be brought into question. In short—to answer the question—in principle it is possible to have a stabilisation fund, but in practice I cannot see that being achieved in the near term. There would be difficulties for macrostabilisation as we could have asymmetric movements in revenue.

John Mason: I presume that, if the oil price was high to start with and we could save some money, the approach would work, but it would be hard to do if the oil price was low to start with.

Professor MacDonald: The price would need to be really high, given what we know about the expenditure side of Scotland's budget. It would need to be much higher than it is today and much higher by historical standards.

John Mason: We have talked about benefits and pensions quite a lot and the word "pooling" was in some of your submissions—it was certainly in Professor MacDonald's. I understand that what Scotland spends as a share of its gross domestic product or tax revenue on pensions and benefits is broadly similar to or slightly less than what the UK spends, so there is no pooling in that area. I presume therefore that it would be quite easy to split pensions and benefits. Is that the case?

Professor MacDonald: I am not sure about the technicalities, but whether you would want to do that is a different issue. The pooling and risk sharing come through common unemployment benefits, for example. If the whole UK moves into recession, people in Scotland who become unemployed go on to common unemployment benefits, which are a shared resource across the UK. Buying into that system means putting a shared amount into the centre. If you were talking about taking that out, you would have to think about what you pay to the centre for other shared items, such as macrostabilisation. It is not entirely clear that taking pensions and benefits out of the overall system would lead to a better outcome.

John Mason: I suppose that I am asking whether Scotland and England are benefiting from the pooling. They are both paying their own way. Pooling is a theoretical concept, but it is not happening at the moment, is it?

Professor MacDonald: It is. If there is a downturn in the Scottish economy but not in the rest of the UK, the current system ensures that resources flow to Scotland. If the link is broken, that will not happen.

Professor Kay: Splitting is not a nightmare in revenue and expenditure terms, but it is a nightmare in administrative terms. The splitting of pensions is one of those problems that, if one had to solve it, one would, but it would involve facing up to an unpleasant group of administrative issues.

John Mason: You have mentioned the costs of setting up a separate system; I suppose that that is what you are talking about again.

It has also been mentioned today that the UK has an incredibly complex income tax system, plus we are running income tax and national insurance in parallel. Would it be possible for Scotland to have a much simpler principles-based system and to combine income tax and national insurance?

Professor Kay: It would, although one should not exaggerate the extent to which one can have a simple income tax system. Income is an inherently complex concept. I say that because a lot of people have ideas that income tax legislation can be defined on one or two sheets of paper, and it really cannot. It does not have to be as many thousands of sheets of paper as it is, but it has to be quite a lot.

John Mason: The issue is complex. I will take that point on board.

My next question is about how different taxes, such as income tax and capital gains tax, are linked to each other. It is true that income tax and corporation tax are linked, because people will incorporate or unincorporate depending on what suits them. Does that make the argument that it is better to have a bundle of taxes that are tied together, rather than just have one or two?

Professor Kay: There is such an argument. It would become a serious argument if the structure and base of income tax in Scotland were to be materially different from that in England. If that happened, one would have to worry about the relationship between income tax and corporation tax as far as small businesses are concerned. However, I do not think that there is a large issue at the level of a few points' difference, which is all that we could realistically be talking about.

Professor Heald: The UK had an issue in the 2000s because of the starting rate of corporation tax. I was reading a relatively old Institute for Fiscal Studies green budget report that made the point that there was a significant rush to incorporate because of the starting rate of corporation tax. Interestingly, the level of incorporations did not fall back to the previous position when that starting rate was abolished.

I agree that, if a Scottish income tax is run, the relationship to corporation tax is significant, although that would not persuade me to want to devolve corporation tax. That is one of the difficult interfaces.

Professor Kay: What Professor Heald referred to was a foolish policy, which one hopes no one will adopt again.

John Mason: A comment was made about a possible race to the bottom—Professor Heald mentioned that in his submission—especially on air passenger duty, although inheritance tax was mentioned as well. Another argument on devolving air passenger duty is that the UK as a whole could get more tourists. It would not just be the case that more people came to Scotland and fewer to England. More people might come to the UK instead of France or Germany if it was cheaper to come here. Is that argument valid?

Professor Heald: Traffic might be diverted and generated. It is interesting that Northern Ireland has partial devolution of air passenger duty and there is one long-haul flight out of Belfast international airport. Clearly, that does not have a significant effect on the rest of the UK. However, if Scotland significantly reduced air passenger duty, I presume that that would have some effect on north of England airports, so it would create internal political trouble in the UK.

I have no idea what the European Commission would say with regard to state aid. In relation to tax, I would not want to have too many disputes with the European Commission and the European Court of Justice about what constitutes state aid and what does not.

John Mason: At the moment, tons of people go down to Manchester to fly from there.

Professor Heald: That relates to the significance of Manchester as a hub.

John Mason: The experience of the land and buildings transaction tax has been that we have made it more progressive. The land cannot move, so we hope that we will get more money from the richer and less from the poorer. Could inheritance not be used in that way as well, as most inheritance tax stuff is fixed?

Professor Heald: I am by no means an inheritance tax expert, but I suspect that such a change would quickly enter into the tax planning calculation. If there were different inheritance tax rates in the UK that depended on the person's residence, lots of inheritance tax schemes would be sold.

If the question is whether Scotland could raise more money by having higher inheritance tax than the rest of the UK, I would be dubious about whether it could. It would be more likely that Wales—if it had the same power—would attempt to attract into Wales those who pay high levels of income tax, as a way of attracting their current income tax as well as their future inheritance tax.

11:00

Professor Kay: Inheritance tax liability is a slightly complicated mixture of where the property is and where the person who owns it is. That raises quite a complicated group of issues. As Professor Heald mentioned, if inheritance tax were devolved, lowering the tax would start to become more attractive—in order artificially to induce people to purport to be a resident in the country—than raising it by making it more progressive would.

The Convener: That concludes questions from the committee. Time is against us, but I will ask one more question of Professor MacDonald. You talked about the assignment of VAT at 50 per cent. Why did you say 50 per cent and not 90 per cent, 20 per cent or even 100 per cent? Why would 50 per cent be appropriate?

Professor MacDonald: I would not say that the calculations that I did for the committee are definitive; it was simply an illustrative exercise to show how we could get a VFI that was more respectable and more in line with those of other OECD countries. As I said in the submission, the numbers could be tweaked in different directions to get a balance that was more favourable to a particular position. I am not particularly hung up on the actual number.

Professor Heald: The question that I want to ask is this: if there is partial assignment of VAT and VAT revenues go up significantly, is there a reduction to the block grant, and if VAT revenues go down significantly because of a UK tax policy change, is there an increase to the block grant? As soon as we get into assigning taxes, we have to ask what the grant consequences are of a UK change to the tax.

The Convener: Our witnesses have no last points to make, so I thank them for their detailed answers to our questions. Professor Kay will be glad to know that he is well on time to catch his train.

11:02

Meeting suspended.

11:10

On resuming—

Draft Budget Scrutiny 2015-16

The Convener: Our next item of business is an evidence-taking session on the Scottish Government's draft budget for 2015-16. I welcome to the meeting Barry White and Peter Reekie of the Scottish Futures Trust. Members have a copy of the submission, so we will go directly to questions. As always, I will start off before opening up the discussion to colleagues around the table.

It is impressive that the Scottish Futures Trust has made £640 million of savings and benefits and supports 6,700 jobs. Congratulations on your successes in that regard.

I want to query some of the figures that you have presented to us. For example, the introduction to your paper refers, in paragraph 1, to

"£671m of additional investment in 2014-15".

However, when we look at the figures on page 164 of the budget, we see not only that the budget figures do not coincide with your figure but that what is expected to be spent over a three-year period is £195 million less than was estimated only two years ago—£614 million as opposed to £809 million—although the figure that is presented in your paper is a £57 million increase on that £614 million. Can you talk us through those figures? You will recall from our report last year that the committee commented on

"the significant overestimation of the delivery of NPD projects in specific years"

and once again we appear to have a situation in which we have an overestimation.

Barry White (Scottish Futures Trust): Thank you for the opportunity to attend the committee.

Before I respond to that specific question, it is worth my first registering with the committee that I am a director of the company that is working on the M8 project, which is part of the non-profit-distributing programme. I think that it is a courtesy to make sure that the committee is aware of that. I am what is called the public interest director, which is part of the NPD structure. The public interest director protects surpluses and the profit-capping nature of the project. For absolute transparency, I wanted to let you know that I am officially a director, in the Companies House sense, of that company. If it comes to any matters of detail around the M8, I might ask Peter Reekie to talk about them.

On your question about the £671 million, NPD is just one of the things that the Scottish Futures

Trust does. We do many other things. For instance, on low carbon and energy efficiency, we have worked with local authorities to quadruple investment in street lighting. In preparing our paper for the committee, we took the NPD investment and added on what we do with the national housing trust, tax increment financing and the growth accelerator model to show the total additional investment. The growth accelerator model is a recent innovation that is launching a major investment in the centre of Edinburgh, where TIAA Henderson Real Estate is going to invest some £400 million. On additional investment as a whole—investment that is additional to the NPD money, which is the figure that is shown in the budget—we are also looking at national housing trust investment to buy houses out on the market, as well as investment through TIF and the growth accelerator model. Our paper gives the total additional investment figure, over and above NPD, whereas the budget figure is purely an NPD figure.

11:15

The Convener: I did not pick that up, because I thought that there had just been a change since the draft budget was published and because of figures such as that for the national housing trust. The figure for 2015-16 is £42 million. I should perhaps have thought that, given the £57 million gap and the £42 million figure, TIF might account for £15 million, but I did not go through the figures. My apologies for that.

On my broader point, your estimates are considerably lower than they have been, but there seems to be an issue each year around the overestimation of budgets. In the paragraph of your submission relating to schools, for example, you discuss

> "the inability to proceed on common good land, the outturn of statutory consultation processes and land acquisition / ground conditions issues."

I realise that there are things that come up that prevent the delivery of such projects, but why do we still have that overestimation year on year? We know that there is an issue every year with potential delays in projects—we have all experienced that in our constituencies. It is never the other way round, however. You never say, for example, "Well, we actually thought it would be £809 million," when the figure is actually £900 million. You do not seem very cautious in your estimates.

Barry White: We exceeded the estimate for last year by £21 million, so there is movement both ways. The movement this year is something like £142 million from what we said last year. However, £21 million moved forward and something like £89 million moved back, so the actual overall difference over three years is just over £30 million, which is 2 per cent across a total of about £1.7 billion.

We have set out two things for the committee this year. First, we have produced a very clear table showing the main reasons for that movement. We are keen to push for pace, and we are continuing to achieve financial close well ahead of historic norms. The average time from the start of procurement to financial close is still around 17 months across the hub programme and the NPD programme, which is how projects are being procured, whereas the historic norm published by the Treasury is something like 34 or 35 months. We are making rapid progress, and our ambition for the programme has helped to make that progress happen.

Secondly, in considering the forecast for 2015-16—the current budget scrutiny period—we have taken on board what the committee said last year and have added £100 million of contingency. The current profile of work suggests that, for 2015-16, the estimate could be £100 million higher than what we said. Taking on board what the committee has said, we have taken £100 million off. We have always said that there has been uncertainty, and we have reflected that by adding in that contingency.

The Convener: I am sure that colleagues will wish to explore that a wee bit further.

In your letter to John Swinney, you say:

> "The £1bn programme extension will benefit from the lessons learned in delivering the current projects and we are currently putting together detailed implementation plans."

Could you talk us through those "lessons learned"?

Peter Reekie (Scottish Futures Trust): We always learn lessons as we go along. We are learning them within the current programme, and we will learn them with future programmes, too. The first lesson is that it is really important for the construction and other industries to know which projects are coming up and when, so that they can plan their resources accordingly and can build up and put in place the right skills at the right time. We will continue to let the industry know as early as we can about what is coming.

The profile that we have given you is an estimate of future workload; it is not a budget. A lesson for the industry and for all those concerned is probably that when projects happen is less important than the fact that they are coming and, broadly, people need to resource up for them. We will publish detailed information on individual projects at the time that is right for those projects.

We will seek corporate commitment on project timescales and resourcing from the individual bodies that run procurements. An important principle for us across the programme is that, on individual projects, accountability rests with the procuring body for the project. We want to strengthen the commitment of those bodies to delivery and to getting the right resources in place to deliver those projects.

A series of detailed lessons have been shared across the programme already and are available on our website. That information goes into all sorts of commercial and practical details about how to specify buildings so that we get what we want, and about how, commercially, we should pay for those buildings through the payment mechanism, which is quite a detailed formula. We are spreading best practice across the public sector so that we can drive down transaction costs for the public and private sectors in doing these deals. We will continue to learn those lessons.

We will have a focus on getting the right projects and doing the right deals. That is shown by the fact that in the hub programme, for example, for the projects that have been completed there has been less than 0.5 per cent cost growth between the outline business case stage and construction completion, and across the programme from contract award to construction completion we see zero cost growth. We are continuing to learn the lesson that we must get the right projects and do the right deals by getting experienced individuals in locally accountable project teams to do them. That is exactly what we will do over the programme extension.

The Convener: That is impressive, but I take issue with one thing that you said—that when projects happen is not important. I think that that probably is important for the people who are waiting for them.

I turn to the national housing trust, which you said in your submission is

"a joint venture between SFT, private developers and local authorities, allowing affordable housing to be developed without Scottish Government grant subsidy."

I notice from the figures that you have provided that there seems to be a year-on-year decline in the number of homes handed over, from 398 to 325 to 277, which is the figure for next year. In addition, the capital value of those homes averages out at around £150,000 per unit, which seems quite expensive for an affordable home. How big are those homes?

Barry White: They are a variety of sizes. The most popular size is two or three-bedroom properties. We are talking about homes that are being built without grant subsidy, so there is no offsetting of the cost by a grant of £25,000 or £45,000, as might be the case in other areas. In general, the homes in question are in the eastern side of Scotland, so they are in the hotter housing markets. Many of them have been built in Aberdeen and Edinburgh. They are being bought at market rates, and we are using a Government guarantee to get cheaper loans through a partnership, which has allowed them to be rented in the mid-market rent sector without Government grant.

The national housing trust also offers a wider benefit for the residents. As well as getting a below-market rent, quite often their energy costs come down considerably. In addition, they have a highly professional landlord service. The demand for the homes has been very significant. We are looking at ways of building more properties for mid-market rent. We view that as an addition to the Government's other programmes on social housing and council house building. We see the NHT as being a way of bringing in more housing supply, which is a critical challenge that we face as a country.

The Convener: But why are the numbers going down from 398 to 277 over a couple of years?

Barry White: The numbers really flow off the back of a series of procurements. We have procured a number of phases, and houses are handed over as they are built out. We have launched a further procurement with the City of Edinburgh Council for up to 500 homes, so you will see the numbers starting to go up again in future years as an outcome of that.

There is phased procurement and we get blocks handed over. It is very much part of the success that so much has happened already. The work is dependent on the market and market conditions rather than grant funding, so it follows the profile set by the developers when their developments are being built out.

The Convener: On page 3 of your submission, you say that

"the most recent October 2014 industry statistics"

show that

"21% of UK construction contracts and 53% of infrastructure contracts"

were

"awarded ... in Scotland."

That sounds incredibly impressive, but what is the average size of those contracts compared with the average in the UK?

Barry White: The table and figures on page 3 show that, over the past 18 months, construction GDP growth in Scotland has been 9 per cent compared with 7.6 per cent in the rest of the UK. If you stripped London out of the figures for the rest of the UK, you would see on a regional basis just how much construction GDP has grown in Scotland. We do not actually have the separate London figures, but we know that London is a really vibrant construction area.

The diagram on page 3 is by Barbour ABI, which is a well-respected monitor of construction workflow. It publishes the UK Government's construction pipeline, for instance. It monitors the total orders that are placed each month, and the diagram shows the percentages for each area. In June, Barbour ABI reported that half of all public healthcare orders in the UK were placed in Scotland. We show the most recent data, which was published in October. It compares September this year with September last year and it shows that there has been a lot of growth in Scotland, with 34 per cent more this year.

The figures that you quoted—the 21 per cent and the 53 per cent—are percentages of the total UK orders of that type that Barbour ABI has monitored, so they are percentages of the whole UK market orders. I do not know what the total UK market order figure is, but—

The Convener: I just wonder what it is in cash terms. A contract could be worth £100,000 or £10 million, so I do not know that the figures mean a lot in themselves, to be honest.

Barry White: The GDP figures show that the construction industry in Scotland has had strong growth over the past 18 months, and the chart shows that the forward order book is looking strong as well. On the outlook for the industry, Alan Watt from the Civil Engineering Contractors Association has said:

"The core message on workload is pretty heartening not only for work in progress but, importantly, with a very good future outlook as well."

However, he expressed some concerns about skills after that. That issue is concerning all of the industry at present.

The chart shows that the Scottish order book is strong, and that gives industry confidence to recruit. That is why the £1 billion extension to the NPD pipeline is so important. It sends industry a signal that the workflow that is here today, the orders that are coming through and the future workload mean that Scotland is a good place in which to invest in recruitment and skills.

The Convener: Thank you for that. I will ask one final question before I open up the session to colleagues. As I said to you during the suspension, I raised the issue of borrowing with the previous panel. What discussions have you had with the Scottish Government about the planned use of capital borrowing?

Peter Reekie: We have always said that the use of capital budgets and the prioritisation of investments is a matter for the Scottish Government. We are implementers. We have looked at the implementation of the future NPD programme and the £1 billion extension, and we are in discussion with officials all the time about that, the lessons that we have learned and so on.

We have regular discussions at a detailed level on the NPD programme and that form of revenue-funded investment. Decisions on the way that investment is split—what comes out of capital budgets and what is delivered through NPD—are based on the suitability of projects to individual styles of investment. We have always said that the NPD programme and the revenue-funded projects are better suited to larger-scale investments, and that is what we are continuing through the £1 billion extension.

11:30

Jamie Hepburn: Your submission mentions that 6,700 jobs are being supported across the country, which is obviously significant for Scotland as a whole. Can those figures be broken down by project? I am not asking you to detail that here and now, but examples might be helpful. It might be more meaningful to local communities if you could say that a certain project was delivering X number of jobs. Can you provide an example to the committee?

Barry White: The 6,700 figure comes from the general metric that the Government applies, which I think I am right in saying is—

Peter Reekie: Ten to £1 million.

Barry White: So the £671 million translates to 6,700 jobs. The figure is calculated using the Government formula that says that for X amount of expenditure, we get Y number of jobs. We could allocate figures to projects, but we would be doing so simply on a formulaic basis. The figures are calculated on a programme level using that approach rather than being built up from data on specific projects.

Jamie Hepburn: That is useful.

You say that the

"NPD infrastructure investment programme remains one of the largest of its type in Europe".

Can you give us comparisons?

Barry White: The Dutch Government has a very big programme, and the French Government had a very big programme. According to David Smith of *The Sunday Times*,

"The International Monetary Fund, concerned about the slowdown in the eurozone's ... growth, has called for debt-financed infrastructure spending".

I can provide the committee with an update on the evidence that we gave one or two years ago on the relative scale of investment that has been made in other areas. We know from the European Public-Private Partnership Expertise Centre, which publishes statistics on what individual countries do, that, on a per head basis, what we are doing in Scotland is one of the biggest investment programmes in Europe.

The incoming president of the European Commission, Jean-Claude Juncker, has made a major announcement calling for an investment programme of, I think, €300 billion. The challenge that he has set is whether we can do more infrastructure investment that involves public and private investment. We are interested in seeing whether Europe's investment activity starts to increase after the call by the IMF and the challenge set by President Juncker.

Jamie Hepburn: If you could provide the detail that you mentioned, that would be helpful.

On a related point, in your submission you say that

"Scotland's infrastructure activity has risen by 34.4% when compared with September 2013."

You offer some comparative figures for the regions of England and Wales. The figure for Scotland is considerably larger than the next largest increase, 3.1 per cent, which is for the south-east of England. The east of England is down by 12.4 per cent and London is down by 9.5 per cent. That is quite a disparity. Why is that the case?

Barry White: To be fair, the figures show trends rather than absolutes. It may be that London had a very active month in September 2013, so its activity going down by 9 per cent could still mean that a lot of orders were placed. What our submission shows is that, looking back in time—as the GDP growth figures do—as well as looking forward, the impact of the investment plans is considerable.

The budget for 2015-16 shows that approximately £4.5 billion of investment is planned from a capital budget of approximately £2.7 billion. It is clear that in Scotland we are seeing a strong commitment to invest heavily in addition to capital budgets, and that is flowing through in the audit figures.

I do not believe that the rest of the UK is making the same additional investment that we are making through the NPD model. The Welsh Government is considering starting some NPD programmes, and we know that Northern Ireland is talking about it. England has a priority schools-building programme, but the scale is relatively small.

In Scotland, we are using the powers that we have, and we know that more borrowing powers are coming. We have submitted our views on borrowing powers to the Smith commission. We believe that there is a slight inconsistency in the current borrowing powers. Our projection for next year is that NPD could provide more than £900 million of investment, whereas borrowing powers would allow us to make only £300 million of investment. We would argue that, in both cases, the repayments have to be paid from the same pot of money, so having the flexibility to choose whether to use the NPD model or to borrow seems to be a sensible choice for Scotland to have.

Jamie Hepburn: To come back to the convener's point about the national housing trust, you have spoken about the reason for the change in the number of homes delivered each year. Do you have a target for the number of homes to be delivered through the national housing trust?

Barry White: At the start, we set ourselves the target of building 1,000 homes.

Jamie Hepburn: Was that a cumulative target?

Barry White: Yes. We started work on developing the idea of the national housing trust in 2009. It was totally untested—it was a totally innovative idea. While we were working up the concept, the Treasury added a levy to the Public Works Loan Board, and the interest rate went up. We went from a working assumption of 3 per cent to one of 4 per cent almost overnight for the type of borrowing that we would undertake, which would be over five to 10 years.

A raft of things happened and a number of challenges were overcome, but the national housing trust was partly a response to the downturn in the housing market. One of the hidden benefits of the trust has been in Dundee, where it is buying 99 units from a developer. That has allowed the developer to open up a whole site for 200 units—the other 101 units will be sold privately or rented on the private market.

The scheme was aimed partly at providing more affordable rented homes and at helping to stimulate development overall by unlocking sites that would otherwise have remained mothballed. If someone goes to the bank with an agreed purchase agreement for 99 homes, the bank will be much more willing to lend them money to develop the infrastructure of a site.

In its current form, the national housing trust will probably run for one or two more phases—the phase in Edinburgh might be its last. We will have to continue to innovate and find different ways to approach housing, and we are taking on that challenge. Through the trust, we have learned a lot that can be applied to future affordable housing schemes.

Jamie Hepburn: You have almost pre-empted my follow-up question. The trust was devised as a response to the downturn in the housing market but, as the market recovers, you still see a role for it, although it might have to develop and innovate and do different things.

Barry White: The times in which we are working mean that the concept of developing one way of doing things and sticking with it for ever is not a likely outcome. We have to be nimble and willing to adapt and change. We started the national housing trust as a joint venture with private sector developers. We have now branched out and are running it as a joint venture with local authorities. We will continue to look at new ways to proceed. Given the changing economic circumstances and changes in the house-building market, we will have to change and adapt. It is right that we do so, and we welcome that challenge.

The underlying issue is that we need to build more homes. We are looking at that challenge and asking how we can do that, whether in the private rented sector or the affordable housing sector. We need to find more ways of meeting that challenge. The national housing trust has been a fantastic way of addressing the issue, but it will perhaps not continue to operate in its present form into the future.

Jamie Hepburn: As you have said, the bottom line is that we need to build more homes. You have made the point that the trust is—or seems to be—focusing on a few specific areas of the country. Could we roll out the scheme to other areas? Can I look forward to it supporting the building of houses in my constituency of Cumbernauld and Kilsyth? I am not necessarily seeking an absolute commitment for my constituency.

The Convener: He has a couple of sites in mind. [*Laughter*.]

Jamie Hepburn: You take my point, though. Will the scheme be rolled out elsewhere?

Please feel free to commit to building houses in Cumbernauld and Kilsyth.

Barry White: Naturally, we offered every local authority the chance to be part of the scheme. Some grabbed the opportunity and were more willing and able to move forward quickly, and we moved forward with those authorities, which included Dumfries and Galloway, Inverness, Falkirk, Stirling and Dundee. The initiative is widespread, but we need partners who are willing to move quickly and be nimble, and we will work with them wherever they are. There are no barriers set by us.

Jamie Hepburn: Okay—I think I read the message there, and I will take it away.

Michael McMahon: I want to go back to the issue of borrowing. I do not know whether the witnesses will be able to answer my question, but they might be able to help us to understand the way in which the budget might pan out.

The Scottish Government's budget for 2015-16 sets out the three options that are available for borrowing: the national loans fund; the banks, from which we would have to borrow on commercial terms; and the issuing of bonds. The Government has said that, in due course, it will learn which of those methods—or which combination of them—will be used to borrow the £300 million or £400 million.

Have you had any discussions with the Scottish Government about what the most attractive option for the financial sector would be in order to get the projects that will benefit from that borrowing to move forward as speedily as possible?

Peter Reekie: We obviously get market feedback reasonably frequently, because we are dealing with banks and financial institutions on projects and finance deals through the NPD and hub programmes. As for exactly which route Scottish Government borrowing will take, I am sure that the decision will be taken in due course, depending on a detailed assessment that is made at the time.

We know that with the NPD and hub models, we must take into account a wide variety of factors in selecting who to borrow from and which structure to use. One factor is the absolute price of funds from any given source at any given point in time. Another example is the repayment profile. In the NPD and hub programmes, we have a structure whereby we start to repay our financing when the buildings are occupied, so here we have all the additionality of investment that we have already discussed. The unitary charges or repayments start when the buildings are occupied, not immediately when the money is borrowed. The way in which the repayments are made is another important factor, as they are repaid fully over the 25-year life of the building.

I am sure that a detailed assessment will be necessary in relation to not only the cost of finance at any point in time, but other factors such as how quickly borrowing can occur, the repayment profiles and the flexibility in that respect.

Michael McMahon: So, in essence, you are saying that we cannot expect a date on which the Government will announce that it is borrowing £300 million or £400 million through a particular method for specific projects. Is that unlikely?

Barry White: The great flexibility that borrowing offers—which is one of the reasons why we included borrowing powers in our submission to the Smith commission—is that it is not necessary to choose the projects. We can choose to use the money and then borrow to fund the projects, whereas with the NPD model, we have to attach the financing to the project at an early stage. The flexibility of borrowing powers means that, in effect, we can use borrowing to increase the capital budget. If the capital budget from the UK Government is £2.7 billion and you can borrow £300 million on top of that, you can, in effect, express your capital budget as the total of those two things.

Alternatively, you could choose to use the borrowing powers to fund a particular programme, and you could earmark the money for that programme. You would then profile your borrowing powers against that. That is a choice that the Government would have to make. Other countries that borrow to invest have set up funds, such as the building Australia fund and the build America bonds. They make it very clear that the borrowing is for investment and they earmark it as a fund, with the details being published separately. It is not necessary to do that with borrowing.

Our view is that borrowing powers are a very flexible tool in terms of what you do and how you do it. For instance, you could borrow and decide to use the money on anything that you would normally use your capital budget for. That flexibility is one of the big benefits of borrowing powers.

11:45

Michael McMahon: I understand the benefits of the borrowing powers, but there is the downside of having to pay the money back at some point. [*Laughter*.]

As we scrutinise the Scottish Government's draft budget, it is not clear how the borrowing powers are going to be used. That is the point. We know that there are three options available to access that borrowing. I am trying to establish whether we can expect an announcement of how much we are going to borrow—and we know that it will be the maximum—how we are going to do it and what the projects will be. As we move through the financial year, can we expect to see changes in how we borrow and additions to the projects that are being borrowed against? Is that scenario more likely than one that would involve our getting a big-bang announcement that there will be X amount of borrowing for X number of projects, which will be done in a particular way?

Barry White: That is not something that is in my gift to answer. We can help the Government with the technicalities of borrowing, such as whether to adopt a bullet repayment or a repayment profile and whether to go for a 10-year or a 25-year period. That is our area of expertise, and that is where we can add a lot of value. We speak to the market about that. By the way, this is a great time for financing projects. We are getting really attractive rates on the projects that we are financing.

However, I am afraid that we really cannot answer the question that you are asking. Perhaps others would be better placed to answer it. I am sorry about that.

Michael McMahon: That is fine.

Gavin Brown: Item 4 in your submission, which is on page 2 and is headed "Investment for Growth", is really about tax increment financing. You have given us some helpful statistics. The programme for TIF

"is forecast to deliver up to £261m of public sector investment over the period from 2013-14 to 2023-24."

Is it possible to get—perhaps in writing—a breakdown of what you think the profile of that expenditure is likely to be? Will it be fairly light in the early years and mainly loaded towards 2023-24, or is it more front loaded than that? Is it spread evenly? Do you have any sense of the profile of spend for the TIF projects?

Peter Reekie: The overall level of public sector investment is calculated at a high level, based on the enabling projects that the different local authorities involved in the TIF projects believe they will have to deliver. The timing for delivery of each of the projects will be subject to individual decisions that are made under the governance arrangements for each of the TIF areas. We cannot say at this stage that a certain individual project and the budget associated with it will be delivered at a given stage over the programme duration, which is intended to be the full enabling period that TIF supports.

Gavin Brown: I suppose that what you are saying is that it is difficult to be specific.

Peter Reekie: It is.

Gavin Brown: That is fair enough. I accept that. If you come to us in a year's time to report back as part of the budget process, what is the expenditure on TIF likely to be for 2014-15? You have said that it is hard to project too far into the future, but is there a rough projection of what you think will happen in the current financial year? Is it the £9 million that you mentioned?

Barry White: It is the £9 million that we set out in the second paragraph under heading 4. We estimate that that is the likely public spend, but I would really like to come back to what the private sector is doing as a result, because there is a multiplier effect between what we do and what the public sector does. That is the case with projects such as the St James quarter investment that has been agreed in Edinburgh. The biggest prize for us is not the public sector investment but what we can invest in an area that unlocks private sector investment.

Gavin Brown: Let us turn to private sector investment, in that case. You say at the end of that paragraph:

> "Private sector investment of around 5 times this amount (c. £1.3bn) is anticipated to be leveraged."

Is that £1.3 billion, or the five-times multiple, a best-case scenario, a central scenario or a cautious estimate? How likely is the £1.3 billion investment to actually happen?

Barry White: One of the great things about economic investment approaches such as TIF and the growth accelerator model is that they require local authorities to put forward absolutely true business cases, because TIF allows them to borrow in the belief that their business case is right. For example, on the back of the TIF in Glasgow, it is forecast that private sector investment will flow and that there will therefore be an increase in non-domestic rates. After allowing for displacement, the local authority can keep the non-domestic rates.

We find that, when people make business cases under TIF, they really think about them, because they are taking a risk that their forecasts are right. The business case regime around those forecasts means that, if they are overoptimistic, the financial cost of that investment will fall back on the local authority, so we believe that the forecasts are reasonably prudent. They are not necessarily best-case or worst-case forecasts, but the nature of that type of investment means that the business case will not promote overstatement, otherwise the authority would be taking risk back internally.

If you ask people to submit a business case when they are simply applying for a grant, they normally turn it round incredibly quickly, because they will put a business case forward to win a slice of the pie. The TIF regime creates an interesting alignment, because people have to genuinely believe what they are putting forward, as they are taking a risk on their predictions.

Gavin Brown: You talked about displacement. Do the individual local authorities make assumptions about displacement, do they get input from you, or do you have control over that? Who decides in a business case how much displacement there is likely to be? Is there a standard approach?

Barry White: There is not a standard approach, because the nature of the business case will change depending on whether it is for hotels, commercial or retail investment. It is an individual assessment. The local authority will propose a displacement rate and we will assess it along with Government, and at the end of the process there will be an agreed displacement rate. It is not a formulaic approach; it is a matter of judgment.

Gavin Brown: If local authorities were being overoptimistic about displacement, would you tell them that you think they need to adjust their estimates?

Barry White: We have discussions along those lines.

Gavin Brown: I will not ask you for specifics.

NPD projects are also mentioned in your report. Alongside your submission is a letter that you wrote to John Swinney on 7 October. The 2013-14 figure in the table in the letter is £177 million actual. Is that a best-guess actual or is the accounting done so that it is the final figure? What is the status of that figure?

Peter Reekie: That is the figure based on all of the profiles that are now contracted for activity that has taken place in 2013-14.

Gavin Brown: The 2014-15 figure in the table is £614 million. If we do a comparison, taking out the M8 savings, the figure was £757 million a year ago. The changes appear to relate to schools, colleges and community health. Those seem to be the areas where there have been the biggest changes. Will you talk us through the changes to each of those three areas?

Barry White: Peter, do you want to talk about the differences?

Peter Reekie: As we say in the letter, there are a number of areas—principally schools and community health, as Barry White said—and there are different classes of movements.

On schools, it has not been possible to proceed with a number of projects as originally scoped. It might be better to talk about that by way of example, and the Barrhead project is perhaps a good example. The school was announced in September 2012 as part of phase 3 of the Scotland's schools for the future programme, and at that stage East Renfrewshire Council anticipated that the project could be on site within 12 to 18 months of the announcement.

The design was developed pretty rapidly through the hub programme, based on the successful project at Eastwood. The project was just about ready for financial close in the spring of 2014. All the way through the development, the council had a preferred site in mind, which was on common good land. In parallel with the project development, the council did diligence on its ability to build on the site. Unfortunately, after taking that through legal process and, in the end, to the Court of Session, the council was told that it was not able to build on the site. That led to the project being put on hold for about nine months. Only now has the council just about selected another site, and it will have to go though an element of redesign to make the work suitable for the new site and proceed on that basis.

There are some pretty binary points that happen as we go through projects. There are other examples where statutory consultations that councils expected to get through were not supported so they had to change their plans. That is one class of the things that have happened on individual projects.

We are supportive of local authorities and other procuring bodies across Scotland buying the right things. It is really important that we both buy the right things and get the right deal for them. The second class of issues related to schools that we refer to in our letter is where we have had to take time to get the right deal for individual projects. That might involve getting the right commercial deal with a contractor or ensuring that we have the right contract in place for the life-cycle maintenance of the building, because we are not interested in just putting up the right buildings; we are also interested in them being looked after for 25 years.

We will always support authorities, and we occasionally hold projects back through our key stage review process if we do not think that the deal is right for the longer term. With schools, it is principally about getting the right project and the right deal.

There have also been some delays in the community health sector, which is the other area that we mention in our letter. It is a time of pretty quick change in the delivery of health and social care, as you know, and the evolving integration agenda in that area has caused a number of projects to pause for people to think about whether they are the right ones for the long term and to rescope projects to include, in many cases, more local authority involvement.

The integration of health and care services is an example. With that integration, as you can imagine, there is first a redesign of facilities to include more services. Along with that, there is often an opportunity to resite a service and facility that is currently sited on land that is in council ownership, rather than health board ownership. Resiting can lead to redesign, and that means that projects face scrutiny, affordability and value-for-money considerations from two bodies at the same time: the local authority and the health board. That parallel processing of projects through developments in governance generally takes longer than it does if there is only one body involved.

We still believe that the projects will be the right ones because of the extra work that is being done, and because we are bringing bodies together to procure. Bringing bodies together is tricky, but it is absolutely right for those projects.

Those are the main features in relation to schools, health and community projects. As we have said, there are uncertainties, and those are the things that have happened to cause that movement.

12:00

Gavin Brown: You have made a prediction of £954 million of investment for 2015-16. You said in response to the convener that you effectively have a float or some leeway of about £100 million in there. Your central guess is that you might end up doing more than that—you are trying to be cautious.

Clearly, some factors will be outwith your control, and some of the issues that you have just described could conceivably arise in 2015-16, too. Is it your central scenario that the figure will be £954 million for 2015-16? Is it unlikely to be less than that?

Barry White: We have taken a prudent contingency. We would always urge caution, however, when dealing with international financing markets. The finance that we are getting at the moment is coming from literally all around the world. We welcome that, because we are getting great deals on financing. Taking into account what the committee said last year, we believe that the contingency is very helpful in adding certainty, although we still require projects to be done.

Picking up on a point that the convener made earlier, we care enormously about when things happen. However, there is a danger when timing becomes the overriding factor for projects. There is a whole history of public sector projects where a project team has been set a deadline to meet, which forces people to make decisions that are not good long-term decisions.

While we absolutely push for time and pace—we want things to happen as quickly as possible—we will not get ourselves into a position where we end up with wrong decisions being forced because of a deadline. It would be wrong of me to list projects where history has shown that to be the case, but we all know of cases in which a sense of urgency at the start has created a long-term problem.

As Peter Reekie said in relation to the hub programme, a lot of price certainty is being maintained. Affordability is very strong in the hub programme as a result of the decisions that are being made. From that point of view, I would absolutely say yes to pace and to getting things done, but we must not find ourselves in a position where we hand the negotiating position to the private sector. The view could be taken, "We know you've a deadline to meet, so we'll sit back until you concede all our points." We are not having that.

Gavin Brown: That is helpful—I am grateful.

John Mason: I will pick up on one or two points that have already been mentioned.

In your letter to John Swinney, which Gavin Brown has been discussing, you write:

"The figures which we have provided in Annex 1 are a projection of capital investment, not a budget."

The word "estimate" comes in somewhere, too—I think that it might have been used as an alternative for "projection". Could you spell out for us how you view the differences between projection, estimate and budget?

Barry White: You are right that "projection" and "estimate" are largely two words for the same thing—looking forward. It is possible to do a projection based on a set of facts, or based on people's estimates. I am perhaps not helping to make this clearer.

Looking into the future, it is possible to say that a set of commitments that has been made will cost X. That is a projection. If, however, you are projecting into the future and certain things still have to fall into place, that is a projection based on estimated figures. Does that help?

John Mason: I am not sure.

Barry White: I am not sure that I have helped. Peter Reekie is very good at explaining such things.

Peter Reekie: The implication for us of something being a "budget" is the same as all the implications that you know well from scrutiny of the Scottish Government's budget: it is generally set on an annualised basis, and the phrase that is often applied is "Use it or lose it".

In this case, we have a set of projects and we know that they must be paid for in the future out of budgets set for revenue expenditure, out of which the unitary charges for the projects will be met. As I said earlier, the budgetary implication of the projects starts once the project has been completed and is in use. There is a construction period of at least 18 months—or even three years for the larger projects. That runs from the point when we have absolute certainty on the cost, when the contract is signed—under this route, the variation from that point is extraordinarily small—to the point at which the budget implication of the project occurs. That annual profile of budget is well known and well understood, and it can be put into the overall Scottish Government budget.

John Mason: Is it one of the differences that "budget" is very much tied to time, whereas "projection" is more about the overall cost?

Peter Reekie: We are making a projection of the profile of when construction activity happens. In the long term, construction activity is paid for out of revenue budgets but, while it is happening, it is simply a projection of when the activity on the site will take place, which is very important for the construction industry overall and for the jobs that we have talked about. However, it is not an annualised sum that comes out of a particular pot in a particular year.

John Mason: I think that we will leave that issue at this stage.

Mr McMahon was speaking about the difference between NPD and traditional borrowing. You made the point in your submission to the Smith commission that you think that there should be more flexibility. I made the assumption, rightly or wrongly, that all these schemes—PPP, the private finance initiative and NPD—are there only because we cannot use traditional borrowing. Would you argue that, in some cases, NPD is better than traditional borrowing even if traditional borrowing is available?

Barry White: As our chairman would say, we are ecumenical about what we do. We seek value for money. There are countries around the world that have borrowing powers and that still have project finance structures. Germany and France are examples. Both of them have borrowing powers as countries, but they choose to use partnerships with the private sector for autobahn improvements and TGV enhancements, for example.

There are different reasons for doing different things. Our starting point is not an ideological one—far from it; it is one of value for money. It might sometimes be right, for a particularly risky project, to consider whether the private sector is better placed to take the risk and pay the higher cost of finance.

In Scotland, the main benefit that we are getting from NPD is that, under a capital budget, the Aberdeen western peripheral route would probably not be built for five years or more. The availability of budgets would determine when it could be built. Bringing that project forward in time and getting the benefit of it now will help the Aberdeen economy. One of the prime selling points of the Aberdeen international business park, which is in the process of building a headquarters office with an area of a third of a million square feet—there is a tenancy agreement for it now—is the hugely improved road links that will be in place when the AWPR is there. We already knew that projects such as the AWPR or the M8 improvements would start to have an economic impact even before they are finished.

As for being able to accelerate and bring those projects forward—

John Mason: Are you bringing them forward? In effect, NPD is limitless as long as we can afford to repay it, but the capital borrowing is very limited. Is that the problem?

Barry White: Yes, and the point that we are making to the Smith commission is that it would be better to have the choice. We are not saying that one approach is better than the other. One has a lower cost attached to it and offers more flexible borrowing; the other brings in private sector expertise in risk management that might be worth paying for in certain circumstances. What we are saying in our submission to the Smith commission is: if we are paying for this one way or the other, why artificially restrict one approach?

John Mason: That is helpful.

We have touched on mid-market and affordable rent, and I think that the phrase “more affordable rent” was used, in the context of the east coast, where I presume that rents and housing costs are higher. Will you clarify what you mean when you use terms such as “affordable” and “mid-market”? There is no housing association grant involved, so you have to cover all the costs.

For example, someone who is in social rented housing might pay a housing association only a couple of hundred pounds a month in rent, whereas in the private sector they might pay £1,000. That leaves a big gap. Where does the housing that you were talking about fit in that range?

Barry White: It fits at around 80 per cent of market rent. That is the type of level that we are talking about. For someone in a private rented home, who probably has little hope of getting a social rented home, that can be a significant saving. The target market that the national housing trust has largely serviced is typically working households on or around median income. The housing is available to all income groups, but that is probably the group that it is most popular with.

For the households that I am talking about, a large percentage of monthly take-home income often goes on property costs, so to save 20 per cent on rent is significant. In addition, there is the professional landlord service, which gives the householder confidence that they are likely to be able to stay beyond the six-month tenancy agreement if they want to do so—although they have the flexibility to leave. There is also the energy saving cost, which can be a big part of the benefit. For someone who moves from an ageing private rented home to a modern affordable rented house, the energy saving can be enormous.

John Mason: You have painted an attractive picture, but from what you said to Mr Hepburn it sounded like demand is falling. I would have expected it to be increasing.

Barry White: Demand is increasing; the issue is the willingness of house builders.

The partnership works on the basis that builders maintain an investment in the rental sector, which is not their natural way of doing business. Most house builders are set up to build homes and then sell them. During the hard times they are willing to look at alternative models, but right now they are much more readily able to build and sell homes, because mortgage availability has come back a bit and initiatives such as help to buy have enabled people to get into the housing market.

We are not turning the tap off—not at all. It is just that the opportunity to build on the basis that we are talking about depends on market conditions. Market conditions have shifted, so we might not be able to do the same thing for ever. We are operating in a market, rather than in a grant-controlled, decision-making framework.

John Mason: Okay. That makes sense.

Peter Reekie: As you said, there is no HAG in the structure; there is no grant as a form of funding for units. All the long-term funding comes from the people who pay rent.

SFT’s innovation with NHT is to combine private developer equity and local authority borrowing through the Public Works Loan Board, along with a Scottish Government guarantee over elements of that borrowing. As Barry White said, if developers want to deploy their equity elsewhere they will not necessarily want to get involved. Given that there is still a demand for affordable housing, it is then our job to consider how we can continue to innovate, with the tools at our disposal, to enable such housing to be delivered within the funding and financing arrangements that are available.

John Mason: That relates to what you said about looking for a variation.

Peter Reekie: Yes.

12:15

John Mason: On the jobs that have been created, I take the point about you using a formula rather than being able to provide a list of people, but I am wondering whether the jobs are going to men 90 per cent of the time. Do you have any idea where women fit in?

Barry White: I do not. The construction industry is still largely male dominated. I do not know the exact percentages, but that is the reality of the industry—I am not defending it. I could try to find out whether there are more industry figures on the issue. We would like to see change in the industry, and there are a lot of initiatives to encourage more female workers to go into construction.

John Mason: Is the matter discussed at any stage? Is it suggested that the contractor or builder should be an equal opportunities employer and so on?

Barry White: The biggest thing that we do to improve skills and increase opportunity is to do with community benefit clauses and key performance indicators in things like hub. In hub, 80 per cent of the work is flowing to small and medium-sized enterprises, which is where a lot of the training and development of skilled workers takes place. In the NPD programme that Peter Reekie leads, we have pushed community benefits as far as we can do. We can give you examples of the sort of community benefits that are flowing from that in terms of graduate jobs and apprenticeships.

In the construction procurement review, we have been asked to lead on how we can push such benefits as far as possible. Your point about the balance of who works in the construction industry is something that we should look at as part of the review work.

John Mason: Thank you.

The Convener: There are no more questions from members, but I have a final question. This morning, Professor John Kay suggested to us that the Scottish Fiscal Commission should have a role in monitoring future financial obligations that arise from NPD. Do you agree?

Barry White: I think that there will have to be more transparency around future liabilities. Monitoring the long-term commitments that we make is part of what happens if we get extra borrowing powers. If we are to be able to go to the market to borrow, we have to be much more transparent about all that. If the Government wants to issue bonds nationally, for instance, being transparent about liabilities and long-term financial commitments will be an important element. I think that we have led the way by having the 5 per cent cap. That was a Government decision, not an SFT decision, but I think that it was the right thing to do.

Peter Reekie might want to add to that.

Peter Reekie: As Barry White said, ability to repay is what constrains how much one gets to borrow. Whoever we decide has a role in setting and monitoring that element of the economy will obviously take an interest in NPD payments as part of the overall picture. It is important that they do so and that they can easily access completely transparent information on commitments. Part of our job is to be able to provide that information, at programme level and aggregated across all the projects that we overlook. We will continue to do that, to support whichever bodies oversee that element of the economy.

The Convener: Thank you. Does either of you want to make any final points before we wind up the meeting?

Barry White: I thank the committee for its questions. What we have in Scotland is viewed by industry and by partners across Europe as an active programme. Financial institutions are very interested in what we are doing and we have been able to attract great-value finance. Our having the pipeline out there—and the extension to the pipeline that has been announced—has maintained that interest. The European Investment Bank is investing heavily, and Allianz Global Investors invested in the M8, bringing in pension fund money as part of that. We are seeing a lot of international money. While much discussion takes place worldwide about how to get institutional money into infrastructure, we are just getting on and doing it in Scotland, and wonderful projects are going ahead.

The Convener: Thank you for answering our questions.

We agreed at last week's meeting that we would take the next item in private.

12:20

Meeting continued in private until 13:32.

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