The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

FINANCE COMMITTEE

Wednesday 4 November 2015

Session 4

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FINANCE COMMITTEE
27th Meeting 2015, Session 4

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*John Mason (Glasgow Shettleston) (SNP)

COMMITTEE MEMBERS

Jackie Baillie (Dumbarton) (Lab)
*Richard Baker (North East Scotland) (Lab)
*Gavin Brown (Lothian) (Con)
*Mark McDonald (Aberdeen Donside) (SNP)
*Jean Urquhart (Highlands and Islands) (Ind)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Professor David Bell (University of Stirling)
Robert Chote (Office for Budget Responsibility)
Dr Jim Cuthbert
Professor Ronald MacDonald (University of Glasgow)
Mark Taylor (Audit Scotland)

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance Committee

Wednesday 4 November 2015

[The Convener opened the meeting at 09:30]

Decision on Taking Business in Private

The Convener (Kenneth Gibson): Good morning and welcome to the 27th meeting in 2015 of the Finance Committee of the Scottish Parliament. I remind everyone present to turn off any electronic devices, please.

I have received apologies from Jackie Baillie, and Gavin Brown will arrive a bit late.

Our first item of business is to decide whether to take items 5, 6 and 7 in private. Do members agree to do so?

Members *indicated agreement.*

Scottish Fiscal Commission Bill: Stage 1

09:30

The Convener: Our second item of business forms part of our scrutiny of the Scottish Fiscal Commission Bill. First, we will take evidence by videoconference from Robert Chote, who is chairman of the Office for Budget Responsibility. I welcome him to the meeting. He will give us a brief statement, after which we will go to questions.

Robert Chote (Office for Budget Responsibility): Good morning, convener. It is a great pleasure to be with the committee. I apologise for not being with you in person. There ended up being a gap in the diary, but not a gap on the sleeper.

All that I want to say by way of introduction is that the Scottish Fiscal Commission is a great innovation and that we have already established a very good working relationship with it, as we have done with the Scottish Government officials whom we deal with on the devolved taxes forecasts.

One key lesson from international experience with fiscal councils is that there is no one-size-fits-all template. Therefore, in responding to the committee’s questions, I am bound to focus on what has worked well or less well for us, given the tasks that we have been given. That may or may not be a good guide to how things would or should work in Scotland.

I hope that, however things turn out, the arrangements will be set up in such a way that we can co-operate effectively, as we will have to answer some of the same questions, while respecting our respective independence. We are very keen to have an open and collaborative relationship with the commission and, indeed, the Scottish Government. We invite Scottish Government officials and the commission to participate in the meetings at which we discuss our forecasts for the devolved taxes, and we have found that to be useful. I hope that we can carry on in that spirit as the scope of devolution and the commission’s role broaden.

I am happy to take questions.

The Convener: Thank you for that. It is great to have you back at the committee again, albeit not in the flesh, so to speak.

You said in your brief opening statement that there is no template and that it is about what works well and what has not worked so well. What has worked well and what has not worked so well for the OBR?

Robert Chote: Things have worked probably better than I would have expected when things were set up. As Ian Lienert's excellent paper makes clear, we are quite an unusual model in that the task of forecasting has been contracted out to us by the Government rather than our scrutinising the Government's forecasts or producing parallel forecasts. That necessitates a relationship in which we need to have a private interaction with Government officials in the run-up to budgets and autumn statements, and that has worked better than I expected. The working relationship is a good one.

It is interesting that, in a review of external stakeholders, they said that they had confidence in the OBR's work. I was pleased to see that. They attributed that to the quality of the staff and the nature of the day-to-day workings, and they did not put a great deal of emphasis on the formal legal and institutional underpinnings. However, it would be a great mistake to conclude from that that those formal underpinnings do not work. They are an essential backdrop, and the way in which the working relationship operates is conditioned, perhaps subconsciously to a degree, by the knowledge that there is that structure of agreed rules and working relationships.

Although I would not describe this as not working so well, it is clear that there is a more difficult environment in which to demonstrate independence where there is necessary discussion that takes place in private. When I ran the Institute for Fiscal Studies, things were slightly easier because the Government would produce numbers and, after the event, we would look at them, talk about them and say whether we thought that they were too high or too low. There was no interaction. If we had that relationship, we would not add anything to what the IFS did anyway.

I think that the approach has worked. It is necessarily more difficult to persuade people that there is a clean distinction, but I think that it is the only way that we would have added value to what I did for the previous eight years in the old job.

The Convener: Given the position of the OBR and what you have just said, do you feel that the Scottish Fiscal Commission should prepare its own forecast independently of the Scottish Government?

Robert Chote: As I said, we are relatively unusual in doing it ourselves and providing the official forecast. The Netherlands is the only other obvious example of that approach.

If, as the Scottish Government desires, you set up a situation in which it produces the forecast and the commission scrutinises it, the experience from the Irish Fiscal Advisory Council suggests that, with time, the commission will pretty much end up having to do a forecast of its own in order to be able to critique the forecast that it looks at from the Government. There might be a risk in thinking to begin with that the commission can do this, as it were, looking from the sidelines, without getting involved in the mechanics of producing its own forecast. In the Irish experience, over time, they found that that was harder to do.

It might also be harder to do in this context because we could argue that, if people are interested primarily in the view of real gross domestic product growth for the United Kingdom—although producing that is not our key role—a wide variety of other forecasts are available in the public domain. One way of reviewing the reasonableness of a forecast would be to say, "I'm not going to do a forecast of my own and compare it with this forecast. I'm going to look at how it compares with the other forecasts that are out there." In the environment that we are discussing, given the things that the Scottish Government will forecast and the Scottish Fiscal Commission will scrutinise, there is not a wide range of other forecasts to look at. Once again, that leads me in the direction of saying not necessarily that the commission should do the forecast but that, over time, it might find itself wishing to get pretty close to doing its own forecast in order to produce adequate scrutiny.

To date, the commission has focused on whether it believes that the methodologies are reasonable, which is a sensible approach to begin with while the system is being set up. Once the commission has been running for a while, it will come down more to issues such as whether the commission accepts as reasonable the interpretation that the Government has put on recent outturn data and the way in which that data compares with the forecasts. Again, that gets the commission into more of a parallel forecasting mode. It would certainly be a good idea for the commission to have the resources to do that should it wish to do that.

The Convener: You are saying that, even if the commission does not have the role of producing its own forecast, it will de facto more or less do a forecast—maybe in five or 10 years or possibly sooner—in any case.

Robert Chote: It will quite possibly be sooner. A lot of this comes down to reasonableness. The function is set out in the bill as judging whether the forecasts that are produced and the assumptions that are made for non-domestic rates are reasonable. It will be for the commission to define what it means by "reasonable". As I said, to date, it has focused primarily on methodology—very sensibly—but it will get to a point at which it has to ask, "How do we define reasonable?" Will it define "reasonable" in terms of a numerical range of outcomes for a particular forecast that it thinks are acceptable? That range could be quite wide.

At present, the Scottish Government does not publish five-year forecasts. However, if it were to say what would be, from this point, a reasonable range for forecasts of land and buildings transaction tax revenues in five years' time, it could be quite a wide range, because the revenues will depend on movements in house prices and transactions. The decision on where to draw the line between reasonable and unreasonable is not straightforward, but it is implicit in that model.

The Convener: Obviously, you have looked at the bill and the resources behind it in some detail. Do you feel that the Scottish Fiscal Commission will have the resources to be able to do the job? The OBR has much greater resources than the Scottish Fiscal Commission has or is likely to have.

Robert Chote: I think so. I think that Ian Lienert says somewhere in his paper, which I thought was an excellent one, that the Scottish Government's assessment of the resource needs was munificent. From personal experience, I know that the resources that are needed to do the job properly may be rather larger than some people who have not engaged in the process think, so I suspect that the Scottish Government has made quite a good judgment on that rather than an excessively generous one. However, it will depend on the allocation.

You are right to say that we have more resources than are proposed for the Fiscal Commission. We have a wider forecasting remit, but even the resources that we have are nowhere near adequate on their own to do the job that we do. We depend, crucially, on our access not merely to information but to the assistance, time and effort of civil servants, particularly in HM Revenue and Customs and the Department for Work and Pensions, to do our job properly. In effect, we have about 120 people working for us, particularly in the immediate run-up to forecasting events in those departments.

Another issue for the Fiscal Commission is not merely the resources that it has to play with but the expectation about the time and effort that people in Revenue Scotland or the Scottish Government administration will be able to provide in assisting with information about and analysis of the judgments that they have made. It is not just a question of how much cash is in the kitty.

The Convener: You have almost pre-empted my next question. Will you expand on the level of private contact that you have with UK departments and the basis of those discussions? You touched on that to some degree.

Robert Chote: If you were to look at who is devoting most person hours to working for us, you would see that it is HMRC on the various tax forecasts and the DWP on the welfare forecasts.

The key thing to bear in mind is that the forecasts that we produce for welfare and tax spending are our forecasts. The departments provide us with technical assistance by making recommendations about, for example, whether the models that are used to forecast these things should be changed, but whether that happens is always our decision. The departments might have ideas about how to interpret outturn data, but at the end of the day it is our forecast.

I have been pleased that relationships with officials in those departments have been conducted professionally. I rarely get the sense that there is a political spectre lurking behind the officials that I am talking to. I am wary of any occasions when it looks as though the material or assistance that we are being provided with is being clouded by that sort of political intervention. However, as I say, to date that has worked reasonably well.

The other part of the relationship is with HM Treasury. In a sense, it needs us more than we need it. It brings to us the policy measures that the Government is thinking of announcing at a particular fiscal event and we scrutinise them and have a debate about what we think the right numbers are. At the end of the day, the Government can publish its own numbers, but we produce a central forecast, and if we do not like the Government's numbers, we will put different ones in our forecast. We are very transparent about that.

There is quite a lot of contact. A possible lesson for the Scottish environment is that I find the fact that HMRC is at arm's length from the Treasury is a practical and symbolic source of reassurance. I do not know what the relationship between Revenue Scotland and the Scottish Government is or will be like, or the extent to which there is that arm's-length separation. If there is such separation, it will be a source of additional confidence for the commission in the scrutiny work that it does.

The Convener: How do you feel about the Fiscal Commission exerting influence over the forecast at the same time as providing an assessment of reasonableness?

Robert Chote: It is interesting. It is a sort of hybrid model that is being proposed. At one level, obviously, one would hope that there is going to be influence. The whole point of independent scrutiny is that the Government knows that it is being scrutinised and so comes up with more sensible forecasts.

We have the whole debate behind closed doors and we produce the forecast on the same day. In the Scottish context, there are two issues. One is whether the commission exerts influence between the draft budget and the subsequent budget. The commission cited an example in which it said that it thought that some of the assumptions that were made in the non-domestic rates forecast were a bit over-optimistic and the Scottish Government said, "We responded to that between the draft budget and the subsequent budget." That is one way in which influence shows up. The other way is when it shows up in the run-up to the draft budget forecast.

09:45

As I said, it seems to be a hybrid model. In the IFS model, there is no contact before the draft budget. Some time after it comes out, the IFS looks at it and says, "That seems reasonable," "That looks a bit high," or, "That looks a bit low," and it sets out its expectations. If you took that approach, the Scottish Government could presumably decide whether to amend things afterwards. I think that Ian Lienert leans in that direction. As I understand it, however, the proposal is that there will be an interaction in private prior to the draft budget, and there is not necessarily anything wrong with that.

Again, the question of reasonableness is opened up. Do you want the system to work in such a way that the Scottish Government can have a private conversation with the commission in the run-up to publishing the draft budget? Essentially, the Government would be saying, "If we publish this, would you say that it was reasonable? If not, and we published something slightly different, would you say that that was reasonable?" The question is to what extent you want that negotiation to take place in private. I am not sure that the outcomes at the end of the day would necessarily be different.

Our experience suggests that, if there is that sort of debate beforehand, it might be harder to satisfy everybody and demonstrate that the commission is being independent. Clearly, however, there would be more opportunity for the commission to influence the numbers if it has that prior discussion rather than waiting for the draft budget to come out, looking at the numbers at that point and drawing its own conclusions in order to influence the subsequent forecast.

The Convener: Should the Scottish Fiscal Commission have a wider remit? For example, should it look at the sustainability of Scotland's public finances, and particularly the fiscal rules?

Robert Chote: Personally, I see no problem with that. Our remit is drawn fairly widely in that it gives us an overall duty to report on and examine the sustainability of the public finances, and then specific requirements are made of us—in legislation and the charter for budget responsibility—to produce particular reports.

It seems to me that the questions that you asked are good ones and that the Scottish Fiscal Commission would be a good set of people to put them to. I guess that it partly depends on whether university bodies or research institutes are doing that work in the way that, for example, the IFS does it for the UK as a whole. If so, you might argue that there is no point in having the commission do it as well.

It is hard for me to tell at a distance whether there is that range of alternative opinion. If there is not, I would have thought that there would be a good case for the commission having the ability to talk about those things.

The Convener: Should the bill be amended to reflect that?

Robert Chote: The best outcome is probably a broad overarching duty for the commission, with a list of things that are required of it and a list of things that you are clear you do not want it to do. As you are in the process of setting it up, there is a reasonable case for having breadth to start off with so that you do not have to go back and amend the legislation if you want to go in that direction. However, the overall remit question is one of choice and not of how the commission is doing its job. My personal preference would be for the remit to be broader rather than narrower.

The Convener: I have one final area to touch on before I open it up to questions from the committee. Dr Jim Cuthbert, who will give evidence to the committee later, has produced an interesting paper, as he always does. He talks about what he describes as

"the problem forecasting Scottish government's overall revenues"

because

"only about half of the Scottish government's revenues will come from devolved taxes."

He says:

"Forecasting the overall revenues will be a difficult task, quite unlike that undertaken by the OBR when it forecasts the UK government's tax revenues".

The OBR is in a completely different position in its forecasting. In some ways, you can get your teeth into a lot more. Will the situation that the Scottish Fiscal Commission faces make it more difficult to assess or forecast Scotland's finances and so on? How do you feel about the position that the SFC is in, relative to the OBR, in looking at finances and forecasts?

Robert Chote: Jim Cuthbert makes a good point. As you said, we can go into considerable detail, but at the end of the day we produce a comprehensive, bottom-up forecast over a five-year time horizon. It is important to point out that we do not produce a forecast of what we think the most likely outcome will be; we produce a forecast of what we think the most likely outcome will be on currently stated Government policy. That requires us to ask the Government to be clear about what its policy is regarding, for example, public services and expenditure on grants over a five-year period. When we do that, the concrete plans are laid out only for a relatively brief period. For example, at present, we have detailed spending plans set out only for 2015-16. Basically, we get the Government to tell us transparently what it wishes to assume about the total envelope for spending on public services and grants over the subsequent five years. Of course, when we get to 25 November, that will be filled in for most of the Parliament.

Coming back to Jim Cuthbert's point, I note that, if you were doing an overall forecast of revenues for Scotland over a five-year horizon, you would have to make assumptions about what the UK Government's policy was likely to be on grant spending over that period. As I said, we get the Government to be as clear as we can get it to be about that. The challenge for the Scottish Fiscal Commission would be to decide whether to take the UK Government at its word and how to interpret what it said given that there would not be a full breakdown so it would not be known whether particular sorts of grant spending would be more or less protected. Alternatively, would the commission produce a forecast based on how it thought the UK Government might behave over the next five years, rather than on what its stated policies were? That adds in an extra wrinkle of difficulty or an extra set of choices to be made with regard to how the forecasts are done.

The Convener: Thank you very much for that. I open up the session to colleagues round the table. The first colleague to ask questions will be Richard Baker, to be followed by Mark McDonald.

Richard Baker (North East Scotland) (Lab): Thank you, convener, and thank you, Mr Chote, for your very helpful evidence this morning.

You have talked about the importance for the OBR of having effective dialogue with departments of Government and other Government agencies in order to do your job. The right of access to information for our Fiscal Commission is obviously going to be a very important matter for it. We have already suggested that there should be a memorandum of understanding between the Fiscal Commission and other bodies, such as the Scottish Environment Protection Agency, the Scottish Government and Revenue Scotland, so that we can be reassured that it will have the right of access to information.

Do you feel that that needs to be set out in legislation? I do not know what the arrangements are for the OBR on this matter. Should there be something on the face of the bill to that effect, or could there be an agreement between the Fiscal Commission and other agencies?

Robert Chote: I do not think that it necessarily has to be on the face of the bill, because the equivalent arrangement for us is not. However, that is not to say that the memorandum of understanding is not very important. I think that it is an extremely important document in which all the participants in the process set out their expectations of one another on what sort of information is going to be provided and when.

From our point of view, that is even more important, because we have to get to a process whereby we have a fully articulated post-measures forecast on the day of the budget. We need to have deadlines set out by which the Treasury has a right to expect us to produce a forecast of what would happen if there were no changes at a particular point; and we need the Treasury to tell us about the policies by a particular point for us to have time to integrate them later on.

Some of those issues will not arise for the Fiscal Commission in the same way, because it is not doing the forecast. Nonetheless, the memorandum of understanding is very important and useful. As I said, it is a way of setting out expectations. You do not necessarily want to approach it in a very legalistic way so that you can wave it around, but it is certainly always useful to have something as a backstop when you think that you might be getting into disagreements; it is always nice to be able to cite the fact that you had an agreement beforehand and that that is the basis on which you will set out to operate.

I think that the memorandum of understanding is a very useful intermediate step between the legislation at the top and the way in which the day-to-day working relationship operates, which is fundamentally the most important thing at the end. Having that set of agreements in the middle has been very useful for us.

Richard Baker: You say that having those official agreements has been a useful backstop. Have you had to use that backstop very often in your dialogue with other agencies?

Robert Chote: No—not a great deal. Obviously, we have interaction with the Treasury on the material that we are going to publish, because we need to check that our interpretation of the policy decisions that will be announced is correct. Basically, there is a requirement that, when the

Treasury provides input in that direction, it should be on the basis of fact checking and ensuring that our interpretation is right—it is not an opportunity to badger us to change the opinions that we have reached. It is occasionally useful to remind the Treasury of that, but it has not arisen as a serious problem.

Richard Baker: My final question is on forecasting. As I am sure you realise, the committee has been exercised a great deal by the role that the Fiscal Commission should have in forecasting. Your helpful evidence this morning has been that it should perhaps have that role or ability, perhaps at an earlier rather than a later point. You said that, at any rate, a few years down the line, the commission might develop a role in forecasting in order to fulfil its remit of assessing the reasonableness of forecasts.

Is it fair to say that the commission will not be working from a blank sheet of paper in developing that role? I presume that it will be able to consult the OBR. Would you be willing to assist or advise the commission on some of the issues that it will encounter in developing that forecasting role? You have highlighted the importance of not only resources but building up relationships with other people who work in Government, academia and other sectors. Would you be able to assist the commission with that or would it need to develop that itself?

Robert Chote: We are always happy to provide assistance. As I said, in developing the additional methodologies that we have used and each time we update the forecast, we have found it useful to get the input of the Scottish Fiscal Commission and Scottish Government officials when we are addressing those. When you start out on the process—this has been true with the commission to date—you are focused on the overall methodology or approach that you are going to use in developing the forecast. As time goes by, the methodology might not change very much and the key issue then is how to interpret the new news.

If a forecast says that a particular tax is going to raise £200 million a year in each of the next five years and then, in the first year, it raises £100 million, how do you interpret that information? Do you conclude that the later-year forecasts are probably too high or do you say, "Oh well, £200 million a year is probably the best, so it might well overshoot in the other direction next year"? There is no monopoly of wisdom or folly with those sorts of judgments and issues of interpretation.

We will continue to have to produce forecasts for all the things on which the Scottish Fiscal Commission will scrutinise the Scottish Government's forecasts. I am happy to have as open a discussion as we can about that. At the end of the day, it is important that we are independent. The Scottish Government should produce the forecasts that it wants to produce and we should produce the forecasts that we want to. It does not matter if those are different, but it is useful for us to have a shared understanding of why they are different and to be able to explain it to the committee and other people who are interested.

It is important to make the point that there is a world of difference between saying that somebody else's forecast is different and saying that somebody else's forecast is unreasonable. As I say, the big challenge in initial interpretation is how to define reasonableness, particularly when there is not a large cluster of other forecasts of the same thing, so you cannot just say that reasonable is somewhere in the middle of the pack.

Richard Baker: Thank you very much, Mr Chote.

10:00

Mark McDonald (Aberdeen Donside) (SNP): Good morning, Mr Chote. You mentioned that the role of forecasting has, in effect, been contracted out to the OBR. Are you the only ones who are producing forecasts at a UK level?

Robert Chote: We are the only ones who are producing and publishing a fully articulated, disaggregated, bottom-up fiscal forecast. The closest comparator is the annual green budget process of the Institute for Fiscal Studies, which I did for eight years and which is still going on. However, it is fair to say that the IFS now places less emphasis on producing an alternative bottom-up forecast now that we do it. Although it still provides very useful scrutiny of the work that we do, it is not quite the fully articulated alternative forecast that it was.

There is a much larger population of people who produce alternative estimates—there are roughly 35 of them—for the macroeconomic forecast, which is an input into the fiscal forecast. Every month, the Treasury does a round-up of people's forecasts for GDP growth, inflation, the balance of payments and so on, and a much larger number of people produce such forecasts at a UK level. We make sure that, in our reports, we compare the latest forecast that we have produced with the distribution and evolution of those external forecasts.

However, on the fiscal side, many fewer people are producing such forecasts. The story on fiscal forecasts is very different from that on macroeconomic forecasts.

Mark McDonald: The question has been raised whether the Scottish Fiscal Commission should produce its own forecasts alongside those that the Government produces. I wondered whether that is happening at a UK level, but you seem to be saying that, for fiscal forecasting, the OBR is the only game in town.

Robert Chote: We are the only game in town for producing a really big, bottom-up forecast. City forecasters and academic institute forecasters produce forecasts for, for example, public sector borrowing—the headline budget deficit—but I suspect that quite a lot of those start with our forecast and then say whether the figure is likely to be higher or lower on the basis of whether economic growth or inflation is likely to be higher or lower than the OBR assumes. They may take a different view of oil prices or something like that. There are forecasts of the headline fiscal variables, but they are not generated from the bottom up, from lots of different forecasts for particular tax receipts and particular bits of spending, in the way that ours are.

Mark McDonald: The Cabinet Secretary for Finance, Constitution and Economy, John Swinney, has told the committee that the Fiscal Commission exercises a kind of veto in the sense that, if it believed that his projections were unreasonable, he would not feel able to continue with those projections but would have to revise them. Is there a similar check and balance on the forecasting that is being done at a UK level?

Robert Chote: In a sense, you have to flip it round. We produce our forecast on the basis of our best judgment, and the Government must decide whether to set policy on the basis of our forecast or whether to say, “We think things are going to turn out differently,” and, accordingly, set its forecast in a different way. I am sure that the Government does not accept every last bit of our forecast but, to date, on each occasion on which we have produced a forecast, the chancellor has been happy to use that forecast as the basis for the fiscal decisions that he has made and the narrative that he has set out. For example, from 2012 we started to forecast that the Government would no longer achieve its target of a falling debt-to-GDP ratio in 2015-16. The Government’s response was to accept our forecast, but it was happier to miss the target than to announce an additional fiscal tightening that would be needed to hit it.

That is a useful and transparent process. For one thing, it demonstrates that we are willing to tell the Government unpleasant stories such as that it is not going to achieve what it has set out to achieve. Secondly, it is absolutely right that it is for elected ministers to decide what to do about that and whether it is more important to hit a target or to achieve some other objectives. Thirdly, experience has shown that the decision can go either way. Sometimes, we have told the Government that it will not hit its target if it does not take policy action and it has taken policy action to hit the target; sometimes, we have told the Government that it will not hit its target and it has said, “Fair enough. We’ll have to live with that. We think that’s better than the alternative.”

As I said, the area of responsibility is flipped round. It is for the Government to respond to us; it is not for us to respond to the Government. That is the opposite of the way in which things would operate under the Scottish Government model.

Mark McDonald: You have said that it is for ministers to choose whether to take your forecasts on board. It has not happened yet, but the Treasury and the Government could, in effect, disregard what the OBR has produced if they felt that they wanted to pursue a policy objective that was at variance with what you have suggested.

Robert Chote: They could say that they did not believe the forecast and that they would operate on a different basis. They would have to make a decision on how much detail they wanted to be set out in the forecast. That would not be catastrophic for the system. Reasonable people can disagree about economic forecasts. Anybody who has conducted, read or used them knows that. That would not be a disaster.

There is a separate issue about policy advice. We clearly do not provide policy recommendations. If, in our view, the Government is not on course to hit its target, it is not our job to say whether it ought to do what is necessary to hit the target, or whether it would be better to miss it. For quite a lot of fiscal councils in other countries, it is part of their responsibility to say, “You’re not on target, and this is what we think you ought to do about it.” That is not part of our responsibility. It is the quid pro quo for having a very detailed role in the forecasting process, with the interaction with Government that that implies.

The counterpart to that is that we should not be providing policy advice. We are providing the numbers, and it is for other people to draw the policy conclusions from that. I am not sure, looking at the bill, whether the idea is that the commission should recommend particular policies or particular actions if the numbers are coming out in a particular way, or whether, as I understand it to be, it is more a matter of asking whether the numbers are reasonable—as opposed to suggesting what to do about it if they are not.

Mark McDonald: I do not think that that is the suggestion. I was not trying to imply that the OBR would or should recommend policy.

When we have considered LBTT, income forecasts have been produced by the Scottish Government and by the UK Government via the OBR. Those were at variance, particularly when it came to deciding the block grant adjustment.

Scottish Government forecasts will be subjected to scrutiny by the Scottish Fiscal Commission for reasonableness. What check or balance would there be on OBR or UK Government projections to the same extent, particularly when they turn out to be at variance with Scottish Government projections?

Robert Chote: We will obviously be transparent, and we produce a very detailed publication explaining why our forecasts change from one forecast to the next. As you know, we produce a specific paper on the details of the devolved tax forecast. When we discuss those forecasts, we have representatives of the Scottish Government and the Scottish Fiscal Commission in the room, via telephone more often than physically. They are there as we discuss, for instance, how we ought to interpret recent outturn data, why shares have moved or whether there is any evidence on whether Scottish house prices are moving differently from those in the rest of the UK.

We will then produce our forecast. I do not think that there is any need to worry if we have a different forecast from that of the Scottish Government, particularly on matters such as LBTT. Taxes on property transactions inevitably swing around a lot more than taxes on income or consumer spending, because they depend in part on house prices, which can move around quite a lot, and on the level of transactions—how many purchases and sales are taking place.

It is useful to have a shared recognition on both sides of the table that, even if we do not come up with the same answer, a sharing of information and understanding and a discussion of how to interpret the information are useful to us. I hope that it will be useful to the Scottish Government and the Scottish Fiscal Commission in producing the numbers that are required.

For the purposes of the general public and the committee, I suspect that what you would most like is, if the numbers were different and I or the Scottish Fiscal Commission came to you and tried to explain why they were different, our having a shared understanding of why that was. That may be because the forecast was done at a different time of year or because you took a different view of what a particular economic determinant of that forecast—house prices or transactions, for example—would do, or it may be down to the fact that we had chosen a different methodology to produce the forecast.

I am very keen that we have a free discussion about that, and I hope that the Scottish Government will see that we obviously have a responsibility to the citizens of Scotland as much as to everybody else to produce the best UK forecasts that we can. We are very happy to discuss the approaches that we are taking and our judgments, and I hope that the Government and the commission will be happy to do that as well. We will not necessarily get the same answers, but we would then all understand better where each other was coming from.

Mark McDonald: Thank you.

John Mason (Glasgow Shettleston) (SNP): Obviously, we have covered quite a lot of ground already. Earlier, you mentioned the body in Ireland, which started off one way and evolved—I do not know whether that word was used—or slightly changed how it did things and developed more forecasting ability. It has been suggested in some submissions to the committee that the SFC will just need to evolve, especially because we may get more powers in the future. Has the OBR evolved over the years, or has it been very much a fixed entity?

Robert Chote: The OBR has been largely fixed. The main additions to our role will be through the Scotland Act 2012. Obviously, when we started out, we did not know that we would be doing devolved tax forecasts, but we will. That has probably been the major change in the remit.

On the process, obviously we have tweaked and refined the nature of the publications that we produce as we have gone along, and we have been able to produce different sorts of material as we have gone further.

On the next change that is coming up, the charter for budget responsibility has been revised such that we will now produce a specific publication on fiscal risks, probably every two years. I look forward to discussing with Jim Cuthbert, among others, how one would set about that process. A lot of other countries do that, either at finance ministry or fiscal council level. It will mean that we must bring together a lot of the work that we already do on things such as sensitivity analysis and highlighting risks, and perhaps focus it all in a single publication.

Those are the main changes that we have seen so far. Other proposals for us—that we should start to look at opposition party policies and do distributional analyses, for example—have been raised at various times but rejected. However, the core economic and fiscal forecasting role has basically been unchanged. We have developed and refined it as we have gone along, but there has not been a big shift.

John Mason: Within your remit, do you have the freedom to produce more or fewer reports and freedom in how you produce the reports, for example?

Robert Chote: The charter for budget responsibility sets out some things that we must produce. We had previously to produce a fiscal sustainability report every year, but we can now make the interpretation, in effect, that we have to produce that once every two years, which will allow us to alternate it with the fiscal risk report. We are required to produce forecasts twice a year to accompany the budget and the autumn statement, and to produce a report that looks back and compares our forecast performance with the outturns in data.

However, the overarching duty, which we are allowed to fulfil as we want, has allowed us to produce, for example, a detailed working paper on why public finances evolved as they did over the course of the recession, the financial crisis and then the subsequent improvement. We have also produced papers on particular measures of inflation.

There is scope for us to produce additional material that we think is helpful in fulfilling our overall duty of reporting on and explaining our views on the sustainability of the public finances.

I go back to my initial response to the convener: there is an overarching duty, and there are things that we can do and things that we cannot do. That is the context in which we operate.

John Mason: That is helpful. It has been suggested that those are things that the Scottish Fiscal Commission should also be able to do. Another suggestion is that the Scottish Parliament might ask the Fiscal Commission to produce extra reports. Is the OBR asked to do such work?

10:15

Robert Chote: Occasionally, we are asked for particular bits of information. We try to be responsive not just to parliamentarians but to other people who might ask about our forecasts, about whether we can publish additional data and so on. We do not have a pot of spare resources that allows us to take regular commissions from people who might want a big report on X or Y. If people make the case that it might, as part of our duties, be helpful if we were to look in more detail at oil prices and so on, we might take that on board, but we do not have a huge slush fund of uncommitted resources that we deploy on particular wheezes that people come up with.

John Mason: That is useful. I suspect that it will be the same for the SFC.

We are trying to deal with relationships and independence, but we keep hearing different suggestions. At one extreme, it has been suggested that there should be a very interactive approach, with the SFC being able to influence things as they go along, while at the other extreme we have been told that the SFC should have a much more formal arrangement in which we would know that, for example, it will meet ministers on specific days. How do you get that balance right? How have you found that to be?

Robert Chote: It is not straightforward to set that sort of thing out in advance, rather than see how the process works in practice. We make a distinction in that respect. On the one hand, there are the interactions that we have with Government ministers, their political advisers and their private offices—we log, on our website, our meetings with them when particular forecast material has formally passed over in one direction or another, and so on. That is important and useful.

On the other hand, we rely enormously on a good interactive day-to-day working relationship at staff level between, for example, the officials in our office who look at the details of the revenue forecasts and the HMRC officials who are working on those forecasts. It is very important to us that that relationship works unimpeded, that there is mutual respect and that we do not get a sense that the people in HMRC, the Treasury or the DWP are being leaned on by their political masters in respect of their willingness to co-operate on that basis.

When we embarked on the process, my Swedish counterpart said that he just did not think that the OBR could be genuinely independent with that sort of behind-the-scenes interaction. However, as I have said, if we did not have it, we would not be adding anything to what the IFS already does.

In Scotland, you have a slightly different opportunity, because you have a draft budget before the full one. In that world, there might be no interaction prior to the draft budget; the commission would then come in and there would be an opportunity to take on board any recommendation that it might make. However, at the moment, it is felt that the Government should have an opportunity to take advice on board earlier in order to end up with a "better"—I will put that in quotation marks—forecast at the time of the draft budget. If you do that, you will be in the world of private interaction.

There is a trade-off to be made with regard to how early you want advice and recommendations to be listened to and influence to be felt. From your point of view, having a timely draft budget that is a good guide to what you are going to end up with has its attractions, but the counter side is that, for that to happen, there needs to be private interaction. There is no right answer—you just have to decide where on the spectrum you want to be.

Because the OBR produces the forecast, we are very much at the interaction end of the spectrum. That means that, in order to allay as best we can any concerns that people might have, it is incumbent on us to be as transparent as we can about the process and how our forecasts have moved.

John Mason: That is helpful. Obviously the Scottish situation will be slightly different, but you—and, from what I have seen, other people—seem to be happy with the balance that you have managed to strike between that type of interaction and maintaining a reputation for independence. Do you think that that kind of reputation is as much about the individuals, their integrity and how they are seen as it is about any kind of formally laid-down process?

Robert Chote: That is interesting. That was certainly the conclusion of the review of the OBR that was carried out in 2014 by Kevin Page, the former parliamentary budget officer for Canada. In his survey of external stakeholders such as think tanks and journalists, he asked whether they had confidence in the OBR, and generally the answer was yes. He asked why, and people tended to say that it is to do more with the staff—with the people and how the work is done—than with the formal legislative underpinning. It would, however, be dangerous to conclude from that that the formal legislation and the formal rules do not matter. I think that they do and are an important underpinning.

The other thing that in practice helps to develop a reputation for independence is the first forecast that the office produces that says that the Government will not hit the objectives that it has set itself. People will then say that the office is more independent than they had thought it was. There was, for example, an occasion when the Prime Minister misrepresented—by accident or otherwise—what we had said about the relationship between austerity and economic growth, so I wrote an open letter. It became the lead item on the "Ten O'Clock News", which had an impact on people's views of our independence. Clearly, we do not want to be in a world in which we deliberately go out and pick fights in order to demonstrate independence, but it is the nature of the job that over five years there will have been enough occasions on which we have had to say things that politicians do not want to hear that that reputation can be built up on the basis of how we do business year in, year out.

John Mason: That resonates with the committee; we do that kind of thing as well, sometimes. The final point that I want to touch on is the forecasting. As I understand it, the Treasury forecasting has been contracted out to you—I think that that was the term that was used. One of the comments that we heard from John Swinney and the Government was that if the Scottish Fiscal Commission were to do forecasts, the Government would still have to do forecasts itself, so there would be parallel forecasts. However, from what I understand of the OBR's situation, the Treasury is not doing parallel forecasts and then checking up on you.

Robert Chote: The Treasury is certainly not publishing forecasts: it is not like man-for-man marking on the pitch; it does not have people doing equivalent jobs to every one of our officials. I suspect that the Chancellor of the Exchequer tells his officials that he will get the OBR forecast in a few weeks and will ask what they think that it is likely to say. I suspect that the officials will not go through the whole exercise, but they will want to provide an answer to that question.

The Treasury may well do more scenario analysis around what it thinks are particular risks, in order to inform policy judgment. It is not as though it has got rid of every forecaster or there is nobody doing macroeconomics or fiscal analysis: of course they are. However, the nature of how the Treasury can add value is different, and I do not think that it would add value by completely replicating what we do. It has to provide the chancellor with a commentary on how our forecasts are likely to evolve. That requires that it examine the forecasts, but that is different from just having a parallel set of numbers.

In Korea, I think, and in the United States with the Office of Management and Budget and the Congressional Budget Office, they just have two sets of numbers that they can compare in public. That is not how it works here.

Jean Urquhart (Highlands and Islands) (Ind): Good morning, Mr Chote. As long as this country is not independent, there will be many strands to the communications that go on. If you were heading up the Scottish Fiscal Commission, what relationship with the OBR would you recommend for the commission?

Robert Chote: If my job was to scrutinise the Scottish Government's forecasts, I would want such help from the OBR as we are able to provide in forecasting the same things and in being as transparent as possible with the commission about how we are doing that, on the ground that that would provide useful input to the commission in scrutinising what the Scottish Government does.

We are trying to do that now. We hope that it will be helpful for the Fiscal Commission, in addition to being helpful for us, to have it involved in our discussions around particular forecasts ahead of each autumn statement and ahead of each budget. I hope that the discussions will also be useful to the commission because, although it is not doing a forecast, we are having to answer some of the same sorts of questions. How do we interpret the fact that the revenues of a particular tax came in higher or lower than we and/or the Scottish Government had expected? Is that news or is that just volatility in the data? Is there some way of explaining that? If there is a way of explaining it, do we think that it will persist?

I would like the OBR to be as transparent as possible in how it does its job of giving me raw material that I can use when I am doing my job. I hope that that is what is what we are doing. If it is felt that we can do more, we are happy to do that.

Jean Urquhart: Given that there is, of course, the rest of the budget and the reserved matters that Scotland does not involve itself with, is there a relationship with the Scottish Fiscal Commission and what used to be known as the Scotland Office? How does it fit into the mix with the OBR?

Robert Chote: We have no interaction with the Scotland Office, at all. Depending on how widely the remit of the Scottish Fiscal Commission is set, we might come to a point at which the Scottish Fiscal Commission would necessarily have an interest in more of our forecast than merely what we are forecasting for the devolved taxes. Again, however, we are trying to be as transparent as we can about that, anyway.

If there are particular questions about the rest of the forecast or—to come back to our earlier discussion—the assumptions that we had made about what will happen to Government expenditure over a five-year period, some of which would not be covered by a spending review, there might be more areas of mutual interest. For example, although it is not a devolved issue, there has been a lot of interest from this committee and others about what we have said on the North Sea oil forecasts. However, we hope to be as transparent as we can about those, as well as about the devolved taxes.

Jean Urquhart: There has been criticism of the fact that some members of the SFC are also members of the Scottish Government's Council of Economic Advisers. Do you see any conflict of interests?

Robert Chote: I would say that there is not. My understanding of the nature of the Council of Economic Advisers is that it is not very much involved in the detail of policy formulation. If it were, you might have greater concerns. However, if its members are providing external advice, as academics, I suspect that that is probably not too great an issue. I presume that the work that they do in that role and what they say are relatively transparent. I am not hugely knowledgeable on exactly what the advisers have done, but it does not strike me to start with that there is a problem of a conflict of interests.

The Convener: That concludes questions from committee members. I want to put a couple of final points to you.

Has the Scottish Fiscal Commission had any discussions with the OBR about the methodology for forecasting the devolved taxes?

Robert Chote: We had a discussion with the commission when it was set up. Methodology arises whenever we discuss a particular fiscal event that is taking place. We ask whether the forecasting methodology is working okay, whether there are, for example, asymmetries—the share is rising or falling—in the Scottish share when compared to the UK total, and so on. We discuss those things every time we do the forecasts; I am happy to do so.

The Convener: Is there agreement on how methodologies are deployed?

Robert Chote: We produce our forecasts and we try to be open and to get as much input to them as we can. Obviously, the Scottish Government produces its own forecasts, but it has not asked us to contribute to discussions on those before it publishes them. Again, we would be happy to do that if it wished us to do so.

Take the example of the land and buildings transaction tax. It is evolving from the costing of a new policy into something that will involve forecasts being produced year in, year out. It is useful for us to have a discussion about the best approach to that. Obviously, the Fiscal Commission has produced a paper in which it talks about the methodology for that. When the changes were made, we explained in detail why we had made the forecasts that we made.

In an ideal world, we would have a shared methodology for producing the forecasts, but if we arrived at different judgments about how to apply that methodology or if we produced forecasts at different times of the year, the answers would come out different.

That said, there is no requirement for us to use the same methodology. If we could agree on one that worked for both of us, that would be great, but if people do not agree on the methodology, that would be fine as well. Ideally, we and the Scottish Government, helped by the Fiscal Commission, would be able to explain why the forecasts were different if they were different, but we would not need to be anxious about the fact that they were different. Differences are inevitable in a forecasting process.

10:30

The Convener: So there should be no anxiety about differences between methodologies as long as it can be explained exactly how forecasts are arrived at.

Robert Chote: That is right. LBTT provides a good example again. If we were to use different methodologies, it would be difficult to work out whether accuracy in one forecast was the result of good luck or a better methodology. I suspect that whether a forecast of LBTT at any particular time horizon is accurate in a purely arithmetical sense will depend much less on methods than on whether the forecaster happened to make the right judgment on the level of transactions. Such things are hugely important.

I would be wary of a world in which we had alternative methodologies and expected to have enough data after two or three years to know which was the better methodology. Unfortunately, we need an awfully long run of data to be able to distinguish between luck and judgment. Normally, by the time that we have managed to distinguish between the two, policy has changed and we are not dealing with the same thing anyway. Using the same method is helpful, but it is not a spot-the-ball competition.

The Convener: One of the commission's functions will be to assist the Scottish Government's forecasting of receipts from the Scottish rate of income tax. What level of access to HMRC data will the Scottish Government and the commission require in order to produce those forecasts?

Robert Chote: The commission will, as the OBR does, have to respect taxpayer confidentiality, so there will be a limit to how disaggregated the information that is provided to you can be. The OBR does not have access to all the data, and I do not expect that the Scottish Government or the Scottish Fiscal Commission will have access to all of it. For us, the same issue arises in relation to corporation tax; that can be important because there can be a relatively small number of firms making large contributions in particular sectors. As we have discussed before, the big difference with the Scottish rate of income tax is the fact that we are moving into a world in which taxpayers will be explicitly flagged as being Scottish or non-Scottish taxpayers. We will no longer have to rely on survey estimates of the Scottish share, so that clarification will help both offices.

One important question is how behaviour on both sides of the border is likely to respond to the Scottish rate being different from the UK rate. Who knows whether that will happen? That is the sort of issue on which it would be jolly useful for us to have a discussion with the people who are producing and scrutinising the forecasts in Scotland. It would be interesting to know what they think the answer to that question might be, although I would not be at all surprised if people come up with different answers, because it is a very difficult question to answer.

The Convener: We will put those questions to Professor David Bell in our third evidence session this morning. We will be interested in his answers, as, I am sure, you will be.

That concludes my questions and the committee's. Thank you for assisting the committee by giving evidence this morning. I hope that we will see you in the flesh next time. Is there anything that you want to cover that has not been touched on, or are there any further points that you want to make?

Robert Chote: No. It has been a comprehensive discussion and has covered everything. Thank you very much. I will see you soon.

The Convener: I call a five-minute suspension for a change of witnesses—in this case, also a change in technology—and to give members a natural break.

10:34

Meeting suspended.

10:42

On resuming—

The Convener: We continue our consideration of the Scottish Fiscal Commission Bill by taking evidence from a panel of three witnesses. I welcome to the meeting Dr Jim Cuthbert, Professor Ronald MacDonald and Mark Taylor. Members have received papers submitted by each of our witnesses, so we will go straight to questions.

The first question—it is for you, Mr Taylor—is on something that we have not discussed at all so far in the meeting. I thought that I would freshen things up a wee bit by going to an issue that you refer to in paragraph 16 of your submission. You say:

> "The Smith Commission made a number of proposals about 'no detriment' when fiscal changes are made by the UK or Scottish Governments. This is likely to be difficult to implement in practice, and the Commission could play a useful role in reporting on the mechanisms for achieving no detriment."

I find that paragraph very interesting. Can you expand a wee bit on that role of reporting on the mechanisms and say how it would work in practice in relation to the commission?

Mark Taylor (Audit Scotland): I am certainly happy to do that. I will start with the principles from which that point comes. We think that the Fiscal Commission will play a strong role in giving assurance and helping transparency around all areas of fiscal estimation that affect the Scottish budget. Clearly, one of the key factors in implementation of the Smith commission principles is how the no-detriment principle will work. We think that the commission is likely to have a valuable role in looking at some of that.

I do not think that we have any insight as to how that might work in practice. However, we can speculate that a degree of economic forecasting might be built into the way in which the no-detriment principle works, and that therefore the commission could have a role in looking at that.

The Convener: Thank you. Does either of the other panellists want to comment?

Dr Jim Cuthbert: Yes. Mark Taylor has made a good point that I very much agree with. There is a real danger that discussions about the Scottish budget post Smith will degenerate into a sort of yah-boo exercise between the Scottish Government and Westminster. It would be very important for the Scottish Fiscal Commission to play an independent and well-respected role as an arbitrator in such disputes.

That would be similar to the role that the IFS plays down south. If the IFS comments on a Government policy, that comment is generally taken seriously and people think about it. It would be valuable if the Fiscal Commission could play that role with respect to the arguments and debates about how the post-Smith fiscal arrangements were working.

10:45

The Convener: Am I right that you see an expanded role for the Scottish Fiscal Commission?

Dr Cuthbert: Yes, very much so. I tried to make the point in my submission that although forecasting the devolved tax revenues will be extremely important, the operation of the remaining half of the Scottish budget will be complex. It is not something that has been done well so far.

I was looking recently at an IFS paper on non-domestic rates. You will be aware of the issue. The IFS identified a problem in that regard and estimated that Scotland had gained to the tune of £1 billion, essentially because the Government down south had switched resources away from local authorities and into central Government expenditure. Because the central Government departments have a higher comparability percentage, we therefore benefited through the Barnett formula. In a sense, that slipped through under the radar. There will be much more scope for such points to arise, and they will need to be identified and argued out. The Fiscal Commission should play a huge role in doing that.

The Convener: I will stick with Jim Cuthbert for the moment. In the second paragraph of your submission, you say:

> "the role of assessing risk should, in many ways, be more important than the actual production of forecasts."

That is a continuation of what you have just said, is it not?

Dr Cuthbert: Yes. I very much welcomed what Robert Chote said about the Office for Budget Responsibility starting to produce regular reports on fiscal risk. We have been arguing for that for some time.

Robert Chote perhaps gave a slightly too glowing account of the IFS's success. In many ways, the IFS is overconcentrated on forecasts. I may be doing him a disservice here, but I detected a slight shift in how he talked about forecasts. As I recall, and I may have got this wrong, the IFS always represented its forecasts as median forecasts—in other words, the outcome is as likely to be above the median as below it. However, he definitely said that the current forecast represented the most likely outcome. That is very relevant because I would not regard the current OBR forecast as representing the median. The risks all seem to be on the downside. If there has been a little shift of ground there, that perhaps conceals how some of the risks in the current OBR forecasts are lying, which seems to be on the downside.

The Convener: Professor MacDonald, you say in your submission:

> "It would make sense for an independent body to assess the sustainability of Scotland's public finances and adherence to any fiscal rules devised".

Professor Ronald MacDonald (University of Glasgow): Yes, that is right. I want to link up with what colleagues have said, because we have covered a lot of ground. I agree that, in moving forward, the no-detriment issue must be taken seriously. I know that Jim Cuthbert has highlighted the risks associated with the form of indexation that we may have. As he said, it is important that some group carefully scrutinises how the block grant is adjusted, for example. I have argued to this committee and elsewhere that we should move away from Barnett. If we moved to a more transparent and open system, that might deal with some of the trickier no-detriment problems. The Fiscal Commission could look at that.

In general, I favour the Fiscal Commission having a potentially broader role, because there is no one out there who could do that as an alternative to the commission—if it is set up appropriately.

The Convener: Thank you. I will not jump in on forecasts at the moment—we spent so much time on forecasts in our earlier session that I will leave that to my colleagues.

Professor MacDonald, in your submission you also talk about independence and transparency. You say:

> "I would give priority to independence, transparency and openness in the working relationship between"

the Fiscal Commission, the Scottish Government and other public bodies. You go on to say:

> "I think there should perhaps be a clause ruling out members transferring from a body such as the Council of Economic advisors straight to the FC without any lag in service."

You will have heard Robert Chote being asked a question about that issue. He basically said that as long as there is transparency he does not see any difficulty, given that the people who serve on these bodies tend to be fairly eminent, well-respected individuals. What is your view on that?

Professor MacDonald: As is suggested in my submission, it could work both ways. Someone who has been on the Council of Economic Advisers might want to be seen as even more independent than someone who did not come from that background. There is also that side to it.

The point that I make in my submission is that this is about public perception. Can people who serve on a body that advises Government ministers separate themselves from that advice and be seen as purely independent? We know, for example, that the UK chancellor has a council of economic advisers, and if one of those people was to be appointed to Robert Chote's job, serious questions would be raised.

The Convener: Yes, particularly by Robert Chote, I imagine.

Professor MacDonald: Yes—exactly.

The Convener: The Audit Scotland submission says:

> "Overall the proposals in the Bill appear to provide a significant degree of independence for the Scottish Fiscal Commission. This could be further increased by moving the balance of influence on appointments and financing further towards the Parliament."

How would such a mechanism work? Who within the Parliament would fulfil that role?

Mark Taylor: I guess that detailed questions about arrangements in the Parliament are for the Parliament. The Parliament makes similar appointments through the parliamentary appointment process. Our experience is that that process supports the independence of the Auditor General role, for example, very well.

Our general point is that independence is important. Having the Parliament more involved and ministers less involved would help to deal with some of the issues that are being outlined. The perception of independence is as important as how it happens in practice.

We also make suggestions about how the funding could work, to which the same principle applies. Perceptions around who has control over the funding and financing of the body are important, and we think that anything that moves the balance towards Parliament and away from ministers would help to strengthen the position. That said, a lot of what is in the bill emphasises the independence of that funding, and we give credit for that in our submission.

The Convener: Thank you.

Jim Cuthbert's paper says:

> "The Treasury should be added to the list of bodies with whom the SFC will need to have a good, and well understood, working relationship."

Can you talk to us a wee bit about how you see that relationship working in practice?

Dr Cuthbert: The answer is that I do not know because the Treasury is a strange body. If the Fiscal Commission is to fulfil that broader role of taking an overview of what is happening in the whole budget—I think that that is essential; I certainly recommend it, and I think colleagues do, too—it will have to have assumptions on what will drive the Barnett formula, for example, or the trend in expenditure on devolved public services down south. Ideally, it will need to know a bit about how that trend will shift between different programmes.

I mentioned the importance of the Westminster Government's shift in expenditure from local government to central Government and the effect that that had on the Barnett formula. The Fiscal Commission will need to have information and assumptions about such aspects—and about the aspects that will drive indexation, if we are going to go down the road of Holtham indexation, which will involve assumptions about the growth in the income tax base in the whole of the UK, for example. The only people who can give those assumptions are the Treasury and HMRC. The Treasury will be essential, because the assumptions will depend on Government policy.

However, I do not know how willing Westminster Governments will be to engage in meaningful dialogue on those points, how willing the Treasury will be not to be a dog in the manger, and how one secures the proper co-operation. I think that it will be difficult for the Fiscal Commission to do a proper forecast of the overall Scottish budget without a good relationship with the Treasury and Westminster.

The Convener: You talked about Holtham indexation. In fact, much of your paper actually covers that issue. It also includes some mind-numbing calculus that I will ask Richard Baker to go through for the committee at some point—in private.

I could not let you off without mentioning your comment that

"Scotland would always ultimately be better off under fiscal autonomy than under Holtham indexation".

How did you come to that conclusion? Can you talk a wee bit about your concerns about Holtham indexation?

Dr Cuthbert: The mind-numbing calculus was not primarily for your eyes. It followed on from my appearance before the House of Lords Economic Affairs Committee. I made that point about fiscal autonomy and the House of Lords committee asked for proof. The paper is the proof of that assertion.

Members might remember that, at a previous appearance before the committee, I said that we would not know how the indexation would operate until it was modelled. I then sat down and tried to do some modelling. I published a Fraser of Allander institute paper on modelling the indexation arrangements, which has been sent to the committee and which showed that Holtham indexation, as originally proposed, is very unstable. It has two main drawbacks. It is inequitable because, if the Scottish Government sets a neutral tax rate—the same tax rate as that in the rest of the UK—Holtham indexation would be neutral only if the Scottish tax base grew at the same rate as the rest-of-UK tax base. Given that the rest-of-UK population is growing relative to our population, that would require our per capita tax base to grow faster than that in the rest of the UK. There is therefore an equity point.

However, there is also an instability point. If we failed to meet that neutrality condition—if we fell below it—the revenues of the Scottish Government would go down and down and eventually, if the system was left to itself, they would become negative. That will never happen, but it is an indication of the pressures that are in a sense built into Holtham indexation, unless we meet the target of growing our tax base as fast as the tax base in the rest of the UK. I argued to the House of Lords that Holtham indexation was in essence a non-starter.

Another suggestion that I have made to this committee is that an improvement to Holtham indexation would be to correct the indexation factor for relative population movement. In the Fraser of Allander paper, I worked through the implications of that and it turned out to be a better, although by no means perfect, solution. It is more equitable, in that the neutrality element is that we grow our per capita tax base at the same rate as the per capita tax base in the rest of the UK. It is also more stable, in that, under reasonable assumptions, relative per capita spending will tend to a limit. However, that limit would actually not be politically acceptable, because it implies that per capita spending in Scotland would be about half the level of that in the rest of the UK. I was surprised when the figure of about half tumbled out so neatly from the modelling, but it did.

Therefore, I argued to the House of Lords that pure Holtham indexation is very unacceptable and that adjusted Holtham indexation is not really acceptable. I put forward another proposal altogether, which is that the indexation of the abatement should be based on some fixed factor. It would be indexed at X per cent in real terms, where X is initially some fairly modest factor—say, 1 per cent. That would have big advantages. It would need to be subject to regular review, and the mechanisms for regular review would need to be well understood. I went into that in a bit of detail in the paper for the House of Lords. There would be secondary implications for the indexation problems that we face. It would make the whole indexation and forecasting problem much simpler. We would not need an assumption from the UK Treasury about what was happening to the overall UK devolved tax base; we would just apply the appropriate factor at the time.

There are a number of big advantages in having quite a radical rejig of the indexation arrangements that are currently being worked out by the commission.

The Convener: I will let your colleagues in to comment on that but, obviously, we are talking about the Scottish Fiscal Commission Bill, and we do not want to wander off the subject too much. Professor MacDonald, what is your view on what role the Scottish Fiscal Commission could have in those discussions and details?

Professor MacDonald: I agree with Jim Cuthbert's point. Indeed, I think that I argued in a previous written submission to the committee that we should index the growth of the block grant to a separate fixed factor. I did not do that in quite as sophisticated a way as Jim Cuthbert did; nonetheless, the point was there. Therefore, I agree that, in moving forward, it is important that the issues are addressed, whether or not we retain Barnett and whatever the form of indexation is. As I said earlier, an independent body must look at that. If there is no other independent body in town, it would be good if the Fiscal Commission was tasked with taking forward those issues.

The Convener: Do you share that view, Mr Taylor?

Mark Taylor: I will of course not get into the available policy choices on how the process works, but it is fundamentally important that how it works is clear and transparent and that the public have confidence in how it is working. We see the Fiscal Commission as being able to play a role in relation to how the block grant works and how Barnett functions—if it continues to operate—and how the block grant adjustment works.

11:00

One point that we make in our submission is that we have block grant adjustments now, and there may be a role for the Fiscal Commission in providing some views on how that system is operating at present. That need not necessarily wait until the fiscal framework and the Smith proposals are implemented and considered.

The Convener: Thank you. I will now open up the session to colleagues around the table, as quite a few of them are keen to come in. Gavin Brown will go first, to be followed by the deputy convener.

Gavin Brown (Lothian) (Con): Good morning. My first question is for all or any of you. When we get the next draft budget, which will presumably be at the beginning of next year, we will also get the Fiscal Commission's views on the forecasts for that period. In your view, should we get the forecast for the entire economic period—over three or four years, for example—rather than for the single year of the budget that the forecast sits alongside? Is there merit in having medium-term projections instead of just single-year projections?

Professor MacDonald: I would argue that there is merit in moving towards a longer horizon, largely to address sustainability issues. The UK Government has a medium-term budget forecast. If the Fiscal Commission is to be charged with looking at fiscal rules, which I presume will be—at least in part—about sustainability, the short answer is yes, we need to look at a horizon that is longer than the annual horizon that the commission is currently charged with looking at.

Dr Cuthbert: I agree, although there is a range of different horizons, and it is not necessary to produce forecasts every year for all of them.

Another important requirement is for someone every now and then to look forward 15, 20 or 25 years and ask, "How are things going on present trends? What will the Scottish Government's finances be like on present trends in 15, 20 or 25 years?" An authoritative view on that will be fundamental to the long-term discussion about how Smith is operating and whether any adjustments need to be made.

It will also be fundamental to the Scottish Government's long-term planning for its public expenditure strategy. Every now and then we will need a very long-term forecast; more frequently, we will need medium-term forecasts, and we will need annual forecasts every year. Different forecasts might be needed for different periods.

Gavin Brown: What is your view on having something in the bill that relates to forecasting for the Fiscal Commission? The bill as drafted does not mention forecasting at all. Over the past year, the Scottish Government has said various things, one of which is that it feels that forecasting by the commission would be duplication. However, last week—or it might have been the week before—it basically said that there was nothing in the bill to prevent the Fiscal Commission from doing its own forecasting. The position has been slightly different at different times. Do you think that the bill needs to contain something on forecasting so that, regardless of who is in Government, there is a clear steer on what the Fiscal Commission should be doing, or can that aspect be left out of the bill entirely and the commission itself can decide what to do?

Professor MacDonald: I said in my written submission that there should be something in the current bill, even if the forecasting is not done in the short term.

This is a tricky issue, because, as I again point out in my submission, Scotland is a small country, and we know from previous discussions with the committee that there are data limitations here. One of the civil servants said that it is only a halfway house, which means that any forecasting model that will be produced will be relatively small and tractable. It seems to me that if the Scottish Government is already building and working on a model and we say to the Fiscal Commission that it now has to start building its own model, those models might end up being very similar, especially given the data limitations.

I would argue for a tapered approach. In the short term, the Fiscal Commission can act as scrutineer of the Scottish Government model, but if it is to be truly independent, it should be able to produce its own forecasts. I presume that, as we move forward, the data will become available to produce what might be an alternative to the Scottish Government's forecasting model. Perhaps, in the longer term, the Scottish Fiscal Commission will become a bit more like the OBR and be charged with doing all the forecasting. I have to say that I do not see the point about forecasts being duplicated if in the longer term forecasting becomes more sophisticated and the

Fiscal Commission is to be a truly independent body.

Mark Taylor: From our perspective, it is fundamentally important for it to be open to the Scottish Fiscal Commission to decide how best to assess reasonableness. The bill should ensure that that independence is protected, as we think that there are possibly some risks in being over-prescriptive in that respect.

As has already been reflected this morning, the sentiment in our conversation is about the real opportunities for developing that sort of thing over time. We need to ensure that the role of the Fiscal Commission and its independence are protected in the bill. The committee got some reassurances on that from the Government at its previous meeting, but that is fundamental to how the commission will work in practice.

Dr Cuthbert: I agree with my colleagues. One can always argue both ways, but the important thing is to make the commission's remit broad so that it can make forecasts if it wants to and to ensure that it is resourced appropriately. The commission should certainly be producing long-term forecasts from time to time.

With the forecasting role come certain dangers. It is resource intensive, and there is the duplication aspect. In addition, if the commission is concentrating on forecasting, it might in some circumstances tend—perfectly legitimately—to assume the success of policy and underplay the uncertainties around what is happening. There are arguments to be made in both directions, but we should broaden the commission's remit and resource it well.

Gavin Brown: In their written evidence, Professor MacDonald and Mr Taylor make the point that we should specify in the bill the length of time in which commissioners remain in office. How strongly do you feel about that? Do you think simply on balance that that ought to be done, or do you feel that it is absolutely critical for the exact number of years to be specified in the bill?

Professor MacDonald: Again, it is important for transparency and the commission's independence that, as the cabinet secretary pointed out, there should be a separation between the political cycle and the appointment cycle. I see no reason why that should not be stipulated in the bill.

Mark Taylor: I should clarify that the intent of our submission is not to say explicitly that the bill should make it clear that the period should be X number of years but to say that the bill should enshrine the principle that the cycle of appointments is independent of the electoral cycle. Such a provision could be drafted in a number of ways; it is not necessarily about putting a number in the bill but about enshrining the principle that this is not an appointment that starts at the beginning of and ends at the end of a political period and that it operates entirely independently of politics. That has not been the practice in this country, but that is not to say that it might not be in the future.

Gavin Brown: That is fair enough. Thank you for that clarification.

I will stick with you, Mr Taylor, if that is okay. Interestingly, in paragraph 22 of its submission, Audit Scotland questions whether we might try to shift the balance of influence away from the Scottish Government and more towards the Scottish Parliament. Can you expand on what lies behind that suggestion and how, specifically, that principle could be applied?

Mark Taylor: I touched on that earlier with the convener. Our thinking is that the perception of independence is as important as the practice. Instead of the Parliament having a veto on ministerial decisions for appointment, both ministers and the Parliament will have an interest in who is appointed, but the appointments will ultimately be parliamentary appointments. We suggest that shifting the balance towards Parliament will strengthen the perception of independence that we think is important to the role.

Gavin Brown: When you talk about shifting the balance towards Parliament, are you talking about Parliament as a whole or are you envisaging the Finance Committee having a more proactive role earlier in the process?

Mark Taylor: Again, I would not like to prescribe how Parliament might go about that, but I would expect it to happen at committee level. Given the way in which things are currently constituted, the Finance Committee will have a significant interest in that respect.

Gavin Brown: Dr Cuthbert, you have said in evidence that you do not feel that a copy of any report should go to ministers first. Can you expand on that?

Dr Cuthbert: If there are, as there should be, close working relationships between the Fiscal Commission and civil servants, ministers should have a pretty good idea about what any report is likely to contain. However, giving them a copy too soon or too far in advance will open the door to their occasionally trying to influence what is coming out, and I suggest that a courtesy period of 24 hours before publication, or some other relatively short period, would be appropriate.

John Mason: When, in our questioning of Mr Chote, we suggested that having two bodies—the Fiscal Commission and the Scottish Government—do the forecasting would result in duplication, his answer seemed to be that the UK Treasury did not do any forecasting or, at least, did only little bits just to challenge the OBR. Clearly, there is a resource implication. Dr Cuthbert, you said that the Scottish Fiscal Commission should be resourced appropriately if it wants to do its own forecasts, but that resource might be quite sizeable. In other words, if the commission does its own forecasts, it will need a lot more resource and if it does not, it will not need so much. How do we work our way around that?

Dr Cuthbert: The answer is probably to do pretty much what is done in relation to the OBR. In a sense, the OBR is the forecasting body but, as Robert Chote said, there are 120 civil servants in Whitehall who, at appropriate times, work away on those forecasts. I do not know what the current situation is but when the OBR was set up, it used the Treasury model, and it was important that it developed the capacity to run that model itself, which I think it has. As I understand it, there is a strong symbiotic relationship between the OBR and Whitehall. With that sort of input, you cannot really say that the OBR is doing independent forecasting, but I see nothing wrong with working towards a similar model here.

One safeguard would be to emphasise not so much the production of a forecast and whether it has been produced by the Fiscal Commission or the Government and to have the Fiscal Commission produce a reasoned assessment around that forecast and examine the judgments behind it, the risks that attach to those judgments and the risks that are associated with the forecast, even if it thinks that, on balance, the forecast itself is reasonable. That sort of assessment would increase the Fiscal Commission’s authority and mean that it would not matter so much who produced a forecast or how it was produced.

John Mason: Are you saying that the OBR is not and cannot be completely independent?

Dr Cuthbert: I think that, de facto, that is the case. That is no criticism of its bona fides, but it works extremely closely with Government. As Robert Chote said, 120 civil servants in Whitehall work with or for the OBR at some times. In such circumstances, there will inevitably be not political influence but a lot of cross-fertilisation. The OBR’s forecasts must be influenced by Government thinking.

Furthermore, as I have mentioned, when you forecast certain things in a policy-influencing environment, it is usual for a rational forecast to involve the success of the policy. That is because you are aware that someone out there is pulling levers to try to bring about a particular end and, unless you have strong reasons for believing that those levers have become inoperational and the ship is going to hit the rocks, it is rational to forecast that the policy will succeed. For example, the OBR has always assumed that, at the end of the five-year forecasting period, the Government will have got the economy back on track and will be operating at full capacity in a low-inflation environment. That forecast has been pushed further and further back. It is not that in making that forecast the OBR is politically dependent; it is that, in a policy-influencing environment, that is usually the rational forecast to make.

For both of those reasons, the OBR forecast is not truly independent, but that is no criticism whatever of the bona fides of the OBR people.

John Mason: If I understood Mr Chote correctly, I think that the main people who challenge any forecast made by the OBR are the IFS. If the Scottish Fiscal Commission produced a forecast, who would challenge it?

Dr Cuthbert: My view is that there should be less of an emphasis on the forecast. It does not matter whether it is the Scottish Government or the Fiscal Commission that produces the forecast; what is important is that, as well as the forecast, there is a reasoned assessment that involves the key parameters, the sensitivities to variation in and the risks attaching to those parameters and, beyond that, an assessment of black-swan events whose timing no one can predict. If you had that sort of reasoned assessment around and understanding of the forecast, it would not matter so much who produced it.

11:15

John Mason: Perhaps other members of the panel might comment on that. Professor MacDonald, I note that you use the word “devolution”; indeed, I picked up on that and asked Mr Chote about it. Is that how you see it? Is it your view that we do not want a fixed picture but something that will develop?

Professor MacDonald: That is how I see it. The Scottish Government has already started on its forecasting model, and for the reasons that I mentioned earlier, I expect it to be relatively small. If you were to ask the Fiscal Commission to produce its own model, it would probably end up with something quite similar.

I envisage that, in the first round, the Fiscal Commission will simply comment on and criticise the Scottish Government’s model. As you move out from that, it might choose to develop its own model—as we have said, it should have the ability to do that—or it might decide to develop the Scottish Government’s model. In broad terms, I agree with Jim Cuthbert that, as long as there is transparency about the model, the assumptions that are made and the uncertainty with which we regard those assumptions, either group could run it.

At the end of the day—and I think that this summarises what Robert Chote was saying—forecasting is as much an art as it is a science. We cannot write down an economic model, press a button and get some results out. Even if the world were certain, that would not work. There has to be some art, and the art relates to the assumptions that are made about, say, particular coefficient numbers thrown up by the data that we do not regard as reasonable and about which we must make some assumptions in order to get a reasonable forecast.

As long as the art—the assumptions part—is transparent, either group can produce the forecast. What I am saying is that, in the longer term, we do not need duplication, so either the Scottish Government should continue to produce forecasts or the Fiscal Commission should start to produce them. If the Fiscal Commission is to be an independent group, it might be better to let it take over the running of the model in the longer term. If we do that, we get into the issue that Jim Cuthbert has raised about the fact that there will be civil servant involvement with the group anyway. That kind of involvement will not necessarily compromise the commission's independence because—and I think that this is what Robert Chote was getting at—even though a lot of civil servants are working on the forecast, which is after all a huge model of the whole of the UK economy, they are actually providing data such as customs and excise and pensions figures. Presumably, there are assumptions hidden in there that the OBR does not see, but the big assumptions will be made by the modelling group itself. In that sense, the Fiscal Commission will be independent.

John Mason: Mr Taylor, do you have anything to say on that?

Mark Taylor: The choice of whether the Government or the SFC produces the forecast is obviously a political one. We feel that if the policy position is that the Government produces the forecasts and the SFC assesses reasonableness, the legislation should not box in the Fiscal Commission with regard to that assessment. It would be strange if the legislation said that the Fiscal Commission could not produce forecasts, even if it was thought that that would be the best way to proceed. Of course, there is nothing like that in the legislation, but that is the point that we were making in that respect.

John Mason: The other angle that we are coming at this from is the cost of the whole thing. The more flexibility we have, the less certainty we have over cost, and that becomes a problem for this committee. Presumably the answer would be for the SFC to spend a couple of years in its present situation and then come back and ask for more resources.

Mark Taylor: I do not think that anyone is suggesting that there should be a blank cheque. That organisation will be, as we all are, subject to the strictures of public finance, but a fundamental question is about who makes the decisions on resources and whether the Government is placing itself or future Governments in a position in which it can restrict the Fiscal Commission's ability to do a proper job. The question of where such decisions are made is a fundamentally important one.

John Mason: The point that I was going to raise specifically with you was about the whole concept of independence. In your submission, you state:

> "Audit Scotland, the Auditor General for Scotland and the Accounts Commission have all been set up in ways that establish their independence from the Parliament and the Government".

You then mention some practical issues. Is it the structure of Audit Scotland that makes it independent? In my opinion—indeed, in the opinion of a lot of people—Audit Scotland is seen as being independent and as quite a strong challenger of different parts of Government. Is that because of the structure and the rules that have been set down, or is it because of the professional attitude of your staff?

Mark Taylor: The short answer is both. Robert Chote said that the structure is important. I agree fundamentally with that—the structure is, of course, important—but behaviours, too, are important, as are, in an audit context, the ethics that we apply in our work. In the culture that we have in Audit Scotland, they have been and will continue to be given a fundamental importance, because they condition how we do our work and allow us to engage with Government and others over the course of the year while protecting and maintaining our independence.

From our experience, that engagement helps to reinforce our effectiveness as auditors and our independence, because we have a better handle on what is going on. That means that we are able to discuss some of the nuances of issues as they come up instead of taking a more stilted, formal approach in which we attempt to enact independence in the rules that surround that relationship. However, the short answer to your question is both.

John Mason: I would like to tease that out a little bit more. We have said that the appearance of independence is as important as the reality of it. As I understand it, an auditor will visit or interact with some clients very regularly—perhaps even weekly—right through the year. If that much interaction takes place, is there not always going to be a danger of people not seeing the auditor as independent?

Mark Taylor: In managing that interaction, we are always clear about the cultural importance of independence, and we also have a number of practical rules about how that interaction happens. Our experience is that such on-going interaction is fundamentally important to our ability to do our job well.

We are always clear about that relationship and the professional duties on both parties. At the end of the day, we stand or fall by what we report. As you have acknowledged, there is a strong recognition that Audit Scotland's reports and the audit work that auditors do on its behalf really demonstrate that independence.

John Mason: You mentioned having a culture of independence. Where did that come from? How did you get that?

Mark Taylor: There are some organisational mechanics about value statements and the like, but the ways in which the organisation works reflect something that is very precious to both the Auditor General for Scotland and the Accounts Commission with regard to how they operate and how they expect us as Audit Scotland to operate. That concept of independence was established and the tone set in legislation going back to the establishment of Audit Scotland in the year 2000, but it is also embedded in the audit profession, in how the profession operates and in the ethics behind the work that we do.

The legislation in question has been important in setting the tone of the political discourse with regard to what the body has been set up to do, and it is important that such a tone is set. However, there is then an ownership of that concept of independence within the organisation itself. I expect that something similar will happen as the Scottish Fiscal Commission becomes and continues to operate as a statutory body and continues to protect and engender that independence.

John Mason: Thanks.

Mark McDonald: We have covered quite a lot of ground already, but there are a couple of points that I want to pick up on. Dr Cuthbert, you spoke about the relationship that the SFC would need to have with the Treasury. Robert Chote's view earlier appeared to be that the relationship essentially boiled down to forecasting on devolved taxes. However, it appears from your submission that a wider consideration is the impact on the block grant, which then has an implication for forecasting and for the policy on taxation. Could you go into a bit more detail about that?

Dr Cuthbert: It is an important point. The OBR's role is in some respects very much simpler than the role of a body that is trying to forecast the Scottish Government's budget. In effect, the OBR takes the UK Government's expenditure forecasts and uses them to forecast the economy and various tax revenues. That is very simple. However, anyone who is forecasting the Scottish budget will have to look at not only the devolved Scottish taxes but the operation of the Barnett formula, and I have already gone into some of the difficulties that are involved in that.

These things have not been done well in the past. The operation of the Barnett formula has been a bit of a mystery, and what should have been quite predictable with regard to what was going to happen to the Scottish Government finances has not been picked up. There are other less predictable aspects such as the shift in Whitehall between expenditure on local government and central Government responsibilities, and there are additional complexities in forecasting the operation of the indexation of the abatements for devolved taxes and further difficulties with forecasting the abatements for the no-detriment principle. That process is going to be very complicated, and a lot of the relevant assumptions will come from the Treasury with regard to the evolution of devolved expenditure and the evolution of the tax base and so on down south. A very close working relationship with the Treasury will be essential if you are going to make that kind of forecast.

Mark McDonald: There has been talk about the memorandum of understanding that will need to exist between the SFC and the Scottish Government and possibly Revenue Scotland and others. Does the SFC need an MOU with the Treasury so that the commission can get hold of the data that it requires?

Dr Cuthbert: Absolutely. If the Scottish Fiscal Commission is to have this broader role, which I think is the general view of the committee, it absolutely should have a memorandum of understanding with the Treasury on the data that is required.

Mark McDonald: Do you agree with that, Professor MacDonald? In your submission, you mention not only the MOU but an arbitration mechanism beyond that to deal with disagreements over reasonableness. Can you go into some detail about how that would work? Should that be on the face of the bill, or should it be developed beyond the bill?

Professor MacDonald: First of all, I broadly agree with Jim Cuthbert. If things go ahead as they appear to be at the moment, there will need to be considerable involvement with HMRC. As a result, there should be a memorandum of understanding with it.

Secondly, I believe that I say in my submission that I have a quibble about the use of the term “reasonableness” with regard to the Scottish Fiscal Commission’s access to data or information from the Scottish Government. What I mean is this: what happens if the Scottish Government says, “Well, we don’t think that that’s a reasonable request”? None of the documents seems to refer to any form of arbitration to address that issue. All I was flagging up was that, if the committee thought that that was an issue, it should think about how a rejection of a request for something that was felt to be unreasonable could be addressed.

Mark McDonald: With regard to commissioners’ terms of office, I note that you go beyond the idea of establishing term limits in the bill to suggest that commissioners should have the opportunity to serve two terms instead of just one. Is there any particular reason why you have suggested that?

Professor MacDonald: Not really. It is just that other groups do that; it is the practice at the OBR and certainly on the Bank of England monetary policy committee. If someone is seen to have done a good job in their period in office, there is no reason why they should not be reappointed for a second term. I certainly would not rule that out.

Mark McDonald: I am trying to think of the best way to ask this question, but I think that you and Dr Cuthbert have identified that there would have to be an assessment of the Barnett implications, and I believe that Dr Cuthbert said that many people throughout history have tried very hard, with limited success, to predict what will happen as a result of Barnett. How open will the Treasury need to be in relation to Barnett to ensure meaningful assessment of the Barnett mechanisms and their implications?

11:30

Professor MacDonald: We will need complete transparency on all the assumptions that Jim Cuthbert mentioned with respect to devolved spending, non-devolved spending and the whole issue of indexation. There will need to be complete transparency across all those ranges that impinge on Scottish revenue.

You alluded to the point that Barnett is not a transparent block grant system. That is why I and others have argued that we should be moving away from it. That is perhaps something that the Fiscal Commission should be charged with, along the lines of the Australian body that considers how the block grant should be defined in the first place and how it should evolve over time.

Mark McDonald: That is the Australian Grants Commission.

Professor MacDonald: Yes.

Mark McDonald: I put this question to the whole panel. I think that it was Dr Cuthbert who suggested that the SFC could have an arbitration role between the Scottish Government and the Treasury. When we produced our report on the fiscal framework, we said that there needed to be some form of arbitration mechanism for where disagreements arose between the Scottish Government and the Treasury. First, do you agree with that? Secondly, do you see the SFC as the vehicle for that? I would have some reservations about the SFC being asked to comment on Scottish Government forecasts while at the same time being asked to hold the jackets, as it were, between Scottish Government and Treasury.

Dr Cuthbert: To clarify, I did not mean that the commission should in any sense have a formal arbitration role. What I meant was that it would be good if it established itself as being authoritative and independent in the common view, much like the IFS at present, so that, if it pronounced on something and said, for instance, that, the way things are going, the finances of the Scottish Government will decline by X per cent over the next 10 years, that would be seen as something serious and well researched and would influence the public debate, rather than just having one side in the debate saying one thing and the other side saying something else. However, I was not thinking of it having a formal role in any sense.

Mark McDonald: I see. Thank you for the clarification.

Professor MacDonald: If we need an independent arbiter, perhaps it should be Audit Scotland. [*Laughter*.]

Mark McDonald: Well, Mr Taylor has the opportunity to accept or decline the challenge.

Mark Taylor: I think that I will avoid that opportunity just at the moment, thank you.

Transparency is important, but you cannot take the politics out of this. Ultimately, there will need to be political negotiation and agreements about aspects of the matter. It is impossible to remove that. If the SFC establishes itself as authoritative and independent, as we all hope it will, that will carry weight in those discussions, as will other factors. There should be a recognition that, ultimately, there needs to be agreement on those things. In the short term, that has been demonstrated in the need for political agreement on the block grant adjustment in the current period.

Mark McDonald: I refer to the evidence from Robert Chote. The indication appears to be that the OBR produces forecasts, and nobody else is producing alternative forecasts. I wonder whether, as you seem to have suggested yourself, Dr Cuthbert, we are getting a bit hung up on who produces forecasts and how many forecasts are produced. The question is whether the accuracy and integrity of the forecasts that the Scottish Government produces are properly interrogated. That should be the focus, rather than whether the SFC produces an alternative forecast. What are the panel's views on that?

Mark Taylor: To start with some principles, from our perspective, transparency is important, as I have said before. There is an assurance role in assessing reasonableness, but that is fundamentally in order to support scrutiny and that is where the value comes from. Having that transparency and having the assurance process allows the committee and others to scrutinise, and put forward alternative views on, how robust the system is.

Professor MacDonald: We must remember that, when Robert Chote was talking about other units not doing forecasts, that was for the fiscal side of things. There are other forecasting groups in the UK that do macroeconomic forecasting, which can offer alternative scenarios to that of the OBR, for example. We do not have that in Scotland. Therefore, we perhaps need an independent set of macroeconomic forecasts, at least. If those are being done, it follows that you are as well to do an independent set of revenue forecasts as well.

Dr Cuthbert: My view is that there is indeed a danger of getting too hung up on forecasts. On the other hand, because of the dearth of forecasts, the Fiscal Commission might decide to do forecasts—it should certainly have the capacity to do so—but it need not do so. The important thing is the assessment around that. To use an analogy, supposing one had some money to invest in the stock market, one would not go to a stockbroker and say, "What do you forecast the market will be a year from now?", and act according to that. You might ask him what he thinks the market is going to be, but the really interesting thing will be his assessment of the risks on either side and what events might take place; on the basis of that assessment, you would then form a judgment. We are in much the same position on forecasting. It is important, but we should not get too hung up on it. We should look at the broader picture and the assessment of the risks around the forecasts, which in many ways is more important.

Richard Baker: Following on from that, what I took from some of your earlier comments, Professor MacDonald, although I might have misunderstood, is that you saw the Fiscal Commission potentially taking on a similar role to that of the OBR and becoming the forecaster for the Scottish Government or Scotland as a whole. However, given your comments about the fact that we do not have alternative forecasts in Scotland and have a dearth of forecasts on macroeconomics—certainly in comparison with the UK, which has a number of them—does that make the argument that, on occasions, when it might be justified by assessing reasonableness or even on a more regular basis, it would be good to have a Government forecast and a Fiscal Commission forecast if the Fiscal Commission thought that that was useful, not least to inform parliamentary and other debate on economic policy?

Professor MacDonald: In principle, yes, but we then come back to the point that some committee members raised earlier about the expense of the whole exercise. To have two units doing something very similar will be very expensive, assuming that both are funded from the public purse. That is another aspect to consider.

I agree with Jim Cuthbert that we should not get too hung up on the forecasting. As we said earlier, as long as there is transparency about the assumptions used, it is perhaps unnecessary to have duplication. However, to go back to a point that was raised earlier, it is really for the Scottish Fiscal Commission to decide whether it wants to set up its own model. It would be interesting, though, if the commission decided to set up a very different framework from the model that was being used by the Scottish Government. In that situation, there might be a greater case for allowing the commission to have a different modelling set-up so that we get two very different kinds of forecasting models. That may—I emphasise may—address some of the uncertainty issues that Jim Cuthbert referred to. However, it is obviously not a straightforward situation.

One of the reasons why we do not have alternative outfits forecasting the Scottish economy is that we do not have a very good data set. That goes back to the point that I made earlier that, as the data becomes better, as it surely must if the forecasting exercises get under way, we may see independent forecasters in Scotland starting to develop their own models. That scenario might be going on in the background, which might alleviate the need for two models, one from the Scottish Government and one from the Scottish Fiscal Commission.

Richard Baker: How soon will we be in a position where the data has improved and is more accessible? Is that happening now? How do we get to that point?

Professor MacDonald: I think that you had a piece about this in your most recent report. As I recall, you questioned the civil servants on the issue and I think that they said that it was a "halfway house" at that stage, so we still have some way to go. It goes back to what I said earlier, which is that it is most likely that the initial models that the Scottish Government uses will be relatively small and tractable models because the data is not there to provide for a fuller, more fleshed-out model.

Richard Baker: In that report, we also highlighted some difficulties in accessing data and getting data from different departments. Robert Chote did not seem to be particularly concerned earlier about the memorandum of understanding being in the bill, but you said that it should be. Given Robert Chote's comments, do you still think that it is necessary for the memorandum of understanding to be in the bill? Is it more important to have a detailed and transparent memorandum of understanding?

Professor MacDonald: Yes, as long as there is a truly transparent and well-thought-through memorandum. It would make the Scottish Fiscal Commission more independent and transparent if that was in the bill because, essentially, a memorandum agreement moves people beyond a gentlemen's agreement, and I think that that is what you want to do in this case.

Richard Baker: Do the other panellists have any views on access to data or developing more data, which Professor MacDonald referred to?

Dr Cuthbert: One aspect that we should not neglect is the role of the Office for National Statistics.

Richard Baker: Sure.

Dr Cuthbert: In so far as the forecasting comes down to forecasting the Scottish economy at some stage, that is critically dependent on data from the Office for National Statistics. It has had its problems over the past few years, and it is not clear that they are being sorted out rapidly. A lot of what is going on is not really in the hands of the Scottish Government, and there is an important implication there.

Mark Taylor: There is a distinction between UK data and Scottish Government data. In our paper, we are clear that we think that the rights of access in the bill are sufficient and broadly drawn. I do not think that having more detail and greater specificity in the bill is necessary, because those rights of access are broadly drawn and, we think, quite powerful.

A point to be made about an MOU with the Scottish Government and potentially Revenue Scotland and others is that it is helpful for transparency, and it is helpful that working relationships and the way in which things operate are clear, but care has to be taken to avoid a proliferation of such agreements because, in practice, they could dampen down the rights of access that those in the Scottish Fiscal Commission have. Getting the balance right in how much detail everything needs to be specified in is an important consideration as the Fiscal Commission sets itself up on a statutory basis and begins to develop ways of working.

Richard Baker: Dr Cuthbert made an interesting point about accessing data that is not under the control of the Scottish Government or, indeed, the Scottish Parliament. Perhaps we need to consider that as we look towards the arbitration process for these issues in the future.

Jean Urquhart: We often have discussions about the Barnett formula calculus and the Treasury, and we have taken evidence from different people about that, but there is still mystery around how it operates. We want absolute clarity. Is the word "trust" needed somewhere? I presume that there has to be an element of trust in the relationships between the different organisations.

Dr Cuthbert: Yes, that is right. There must be trust and good will. For example, it is ridiculous that the Treasury has not produced the funding statement. That is the fundamental thing that tells us the comparability percentage for each Whitehall programme, which is one of the key things that drive the Barnett formula. That has not been updated for five or six years. The current operation of the Barnett formula is not up to what it should be, and things will be much more complex in the future. Therefore, there really needs to be a step change in what the Treasury produces and how it goes about that aspect of its functions.

Jean Urquhart: Are you hopeful that that can happen?

Dr Cuthbert: I do not have any insight into what goes on in the Treasury or the Government. The little hints that one gets suggest that they are not being entirely co-operative or reasonable in the current negotiations, but that is very much an outsider's view. Given the Treasury's past record, I am not optimistic, but that is not an informed view.

Professor MacDonald: I have said previously that I do not like the lack of transparency with the Barnett formula and would prefer to move away from it for that and other reasons. I take the point that there has to be trust, good will and co-operation between the relevant parties.

Mark Taylor: I entirely agree that trust is important, but the key ingredients of the operation of bodies such as the Scottish Fiscal Commission, whose primary purpose in my mind is to help to protect and engender the public's trust in how the system works, are as much transparency as possible about how the system works, the assurance role that the body will have, and the scrutiny process that goes on alongside all that. Those are the key ingredients of that trust.

Jean Urquhart: Do you agree that trying to legislate for everything can introduce suspicion? Should we assume a culture of trust to a certain extent when we look at the bill?

Dr Cuthbert: We are into deep water on the whole operation of the United Kingdom post-referendum. It will not work if the system is seen as opposing factions not trusting each other and not co-operating. If we want it to work reasonably, there has to be good will, but I do not know how one achieves the good will that is necessary to make the system work while politicians quite legitimately have different and inconsistent political aspirations. There is a major problem there and, unfortunately, people are liable to suffer in Scotland if there is not openness about how the funding processes work. They will not be properly debated, they will not work equitably and they will not evolve in a proper fashion. There are real dangers in there.

Jean Urquhart: Thank you.

The Convener: That concludes our questions. Do our panellists want to make any further comments before we wind up the session? Is there anything else that they want to add that has not been covered? I see that they do not want to add anything.

I thank the panellists very much for their evidence. We will have another short break to allow a changeover of witnesses and give members a natural break.

11:46

Meeting suspended.

11:51

On resuming—

Scottish Rate of Income Tax

The Convener: Our third item of business is evidence on the Scottish rate of income tax from Professor David Bell. I welcome Professor Bell, our former adviser, to the meeting and invite him to make a short opening statement.

Professor David Bell (University of Stirling): This meeting and the associated papers are important because they place on record the simple point that what you think that you may get if you increase Scotland's income tax by, say, 5 per cent is not necessarily what you will actually get. Multiplying the average additional tax liability by the number of Scottish taxpayers gives an arithmetic estimate of the extra revenue but the outcome may be quite different, because that simple calculation does not take account of how taxpayers' behaviour may change if tax rates change. Changes in taxpayers' behaviour are difficult to predict, and it is very difficult to establish what we call the counterfactual—what would have happened had rates not changed.

One finding on which there is agreement is that increases in taxes lead to reductions in taxable income. That can take a number of forms: taxpayers may reduce their hours, drop out of the labour market, retire or even emigrate. All those responses would lead to lower tax receipts from other taxes as well as from income tax, which might have implications for the second no-detriment principle. Alternatively, taxpayers may reduce their effort at their workplace or negotiate higher wages to offset the higher taxes, which would lead to lower company profits. Finally, they may seek to avoid tax by reclassifying their income as, for example, profits, which would lead to a transfer of tax receipts from Scotland to the rest of the UK.

The group that is most likely to change its behaviour is the very highly paid. Scotland gets about 20 per cent of its total income tax revenues from the top 1 per cent of earners, which means that it faces considerable revenue risk if that group alters its behaviour. To me, that suggests that the Scottish Government must proceed cautiously—ca cannie—when considering significant changes to the structure of income tax in Scotland. It is also worth bearing in mind that the perception of Scotland as a high-tax jurisdiction might affect the behaviour of not only Scottish taxpayers but skilled migrants who might come to Scotland and have the potential to boost the Scottish economy.

The Convener: Thank you. You used the words "significant" and "perception". What is the definition of something that is significant? For example, the committee undertook a two-day study visit to the Basque Country last week, and one of the first things that I asked the minister for finance about was the impact of taxes being a lot higher in the Basque Country. He looked at us in bewilderment and told us that there has been no discernible impact. The Basque Country's GDP is 22 per cent per capita above the Spanish average, its productivity is 28.5 per cent above the Spanish average and its human development index is higher than those of Norway, Sweden and Finland.

Incidentally, it is only 35 minutes by plane to Madrid from Bilbao, which is even closer than London is to us. The view of the people whom we spoke to is that the higher taxation levels had not had any adverse effect. They said that it "was not an issue". The Basque Country more or less raises all its taxes, and it pays 6.24 per cent of all Spain's taxes. It has much higher devolution than we have or are likely to have in the foreseeable future.

Labour elasticity is covered substantially in your paper. Where does that become significant? One could argue that, for the super-rich, even a marginal increase could deter someone. Ultimately, if we are looking to increase revenue, where does that occur on the x-axis and y-axis in the UK context?

Professor Bell: We have quite a strange tax structure: we pay 20 per cent on income between about £10,000 and £42,000, and then pay 40 per cent on income up to £150,000. The big action is more likely to be down towards the lower end of the income tax schedule. I think that we raise about £700 million out of £11 billion from the additional rate. Let us say that we want to raise a lot of money. If we increase the additional rate a lot but there is no behavioural response, we will not get a huge amount of extra revenue. If we move the additional rate and have it kick in at £120,000, that will make a pretty significant difference.

We have to think about both bands and rates. You made a good point about perception. People see rates as the key issue, but bands are as important. What we see in the Scandinavian case is what used to be the case in the UK, where the bandwidths, if we can describe them as that, were smaller, and people moved up steps in a smoother fashion than they do currently. It is at the lower incomes where we would have a big impact on tax revenues. Of course, potentially that has its political costs.

The Convener: It is good that in your paper you included national insurance, so that people can look at the real rate of income tax. People often forget that when income tax goes from 20 to 40 per cent, national insurance goes from 12 to 2 per cent, so there is really an increase of 10 per cent rather than 20 per cent.

You have talked about migration, which is also covered in Professor Gavin McEwen's excellent paper. You said:

> "the flow of migrants into Scotland could be reduced if the higher tax rates in addition to the social and psychological costs deter immigrants."

Professor McEwen said:

> "In a 2014 paper, Anouk Bertier of SPICe"—

the Scottish Parliament information centre—

> "surveyed the evidence for tax-induced migration in Switzerland."

Obviously, Switzerland and Sweden have very high migrant populations, so they are not areas where you would expect there to be, for example, any issue in attracting migrants. Professor McEwen continues:

> "While there is a federal income tax in Switzerland, it is ... relatively low rates and Cantons and Communities have considerable taxing powers including the right to tax income. She reports that two studies she consulted found evidence of high-income taxpayers taking level of taxation into account in choosing their place of residence while one found little such evidence."

There seems to be quite a divergence of views on the issue.

Professor McEwen also talked about the diversity of taxation throughout the United States, with a plethora of corporate taxes, sales taxes and so on. He said:

> "There is undoubtedly competition between authorities, and influence on migration as a result, but the diversity has been remarkably stable and has even tended to increase somewhat."

If we look at pure economic factors, we would clearly expect migration to decrease if taxes went up, but what impact does the expenditure of those taxes actually have? For example, if I am thinking about moving the wife and weans to somewhere, I will be looking at not just a marginal tax rate but the schools, the public realm, the levels of crime, the relative cost of housing and so on. How much of an impact would these marginal rates have if, as you seem to be assuming, Scotland has higher tax rates and if folk are actually looking at Scotland as a place where they can have a higher quality of life?

12:00

Professor Bell: That is a very fair point, and one that I tried to cover in my paper when I discussed the forces that cause people to migrate or not. Typically, it is the young who migrate, and they do so because they gain the benefits of migration over the rest of their lifetime. The better off and the higher earners also tend to migrate because the costs of moving mean less to them than to lower-income people.

Of course, the costs of moving are not just economic; there are psychological and social costs associated with moving from the place where your children are established in school, where your wife or husband has a settled social pattern with groups of friends and so on. As for giving all of that up just for a lower tax rate, I have to say that it is not obvious that that lower tax rate will make the big difference.

The evidence around migration is very mixed. I refer in my submission to a study involving a case in which tax rates were used—successfully—as a specific policy to attract migrants into a jurisdiction. That happened in Denmark, and the paper is by Kleven et al. Tax rates were lowered for a specific group of high earners, which resulted in an increase in the number of high-income-earning migrants into Denmark. Quite a good counterfactual was established with earners who earned slightly less than the threshold at which the lower tax rates kicked in; their numbers did not change, but there was a big influx of very high earners.

There are a number of reasons to be sceptical about applying the same argument to Scotland. That was a specific policy aimed at attracting migrants, and I do not think that, under the powers of the Scotland Bill as currently constituted, Scotland could offer a lower rate of tax to people migrating into Scotland while keeping the same tax rates for residents. Given my understanding that that would not be a potential policy and that it might not be applicable to Scotland—and given that, of course, the situation in Denmark is somewhat different from that in Scotland—it is not clear whether the lesson necessarily applies.

One final point that I would make is that, in general, the costs of migration have probably fallen in the past two or three decades, mainly because of the ease of international travel and the way in which the labour market has become much more international than simply being national or regional.

The Convener: Migration is obviously a key issue. On page 3 of your submission, at the end of that long section 2, you state:

> "During the period 1950-2000, Scotland experienced net emigration of around 900,000".

That is obviously the legendary union dividend coming into play again. Down in London, house prices are phenomenally higher, so younger people who might want to go there have to try somehow to get on the housing ladder. My understanding is that the schools are not exactly top notch for most people and that everything is more expensive.

Assuming that there are higher taxes in Scotland, if we can deliver a reasonable quality of life, a higher level of employment and more equality—the things that we all want—would that not deter emigration on tax grounds? The Basque Country is high on the index of equality. It is much better than anywhere else in Spain and above the European Union average. Incidentally, 29 per cent of the Basque Country's population are immigrants, and most of them are from other parts of Spain rather than from developing countries. Surely, the issue is about what we do with the resources that we have, all else being equal.

Professor Bell: At the moment, the cost of housing in London probably deters potential emigrants in, let us say, the financial sector in Scotland from going down south. On the other hand, if someone is established in the London housing market, a higher tax rate in Scotland might be a negative factor in their consideration of moving up here. People could adopt different strategies around that. That would not necessarily overcome the lack of migrants going down, but I guess that, although it is probably true that for most people the costs of emigration exceed the benefits, we have to be careful about losing even a small number of high earners. We can take the view that that is that but, if the top 1 per cent pay 20 per cent of total revenues, we have to be careful.

The Convener: Let us look at the issue from another point of view. Let us say, for example, that whoever won the election next year decided that they were really worried about the effect of higher taxes and about losing some of the higher earners, so they reduced taxation. What would be the benefit of that to Scotland? Obviously, we would lose tax revenue, which would have an impact on our public services. What would be the economic impact? In other words, is there an equal relationship? Are people as likely to flow into Scotland if we reduce taxes as they are to leave Scotland if we significantly raise taxes? Has any work been done on that?

Professor Bell: No, not that I know of. There would be less of a fall in revenue than we would expect if we just arithmetically worked out the cost—

The Convener: Of course—just as we would never get as much the other way.

Professor Bell: Yes.

We would lose less income tax revenue than might be expected and we might gain a bit of VAT revenue. Of course, if the value of national insurance, the other part of VAT and most other taxes was increased, that money would just go to HMRC. It is important to think about where people are going to come from. If they come from outside the UK, that is of benefit to Scotland and to the UK taxpayer. If they come from other parts of the UK, their increased VAT spend in Scotland will be mirrored by the reduction in VAT south of the border, so HMRC will be no better or worse off as a result.

The Convener: Indeed, but let us say, for example, that we reduced the higher rate by 5p or something like that. The suggestion seems to be that, if we put it up by 5p, that would have a detrimental impact on the number of people who have a domicile in both places classing themselves as Scottish taxpayers. If we were to reduce the rate by 5p, would the amount that we gained offset the amount that we lost? The argument seems to be that we would not gain much by putting the rate up by 5p. Would we gain a lot by putting it down by—taking a random figure—5p? It seems to be considered that that figure would have an impact, whereas it is perceived that a 2 or 3 per cent reduction would not have quite the same impact.

Professor Bell: I refer to Alan Manning's paper and his view on the increase from 45p to 50p that was proposed by the Labour Party at the most recent election. The arithmetic calculation was that UK tax revenues would increase by £3.3 billion. However, Manning's analysis, which was based on behavioural responses and on effects on other tax revenues, was that, depending on elasticities, the figure would range between a gain of £2.8 billion at the top, which was the most optimistic outcome, and a loss of £700 million, which was the most pessimistic outcome. We expect an increase of £3.3 billion if we just do the arithmetic but, in fact, there is a wide range of possible outcomes because of the uncertainty, and the figure would be between -£700 million and +£2.8 billion.

I have no reason to believe that the effect would not be symmetrical if the rate went in the other direction. You would probably lose about four fifths of the tax revenue that you expected to lose if you cut the Scottish rate from, say, 45p to 40p.

The Convener: You are saying that, against the rough prediction of an increase of £400 million by 2018-19—the total for the higher rate would obviously be much lower, but I am just looking at this for arithmetical purposes; I realise that the figure would be about £70 million or £80 million for the higher rate—if we cut the SRIT by 5p, we would regain a fifth of the money that we lost. Let us say that we lost £100 million. We would gain £20 million of that back, so the net loss in overall revenues would be £80 million.

Professor Bell: It might be, but it is difficult to say. At the UK level, migration has not really been an issue, but what has been an issue is people avoiding tax. Manning shows that there is a huge bunching of the earnings of self-employed directors at just below £150,000. They are taking the rest of the money as profits. There is no reason why there would not be that reaction in Scotland if you bumped rates up, and there might be the reverse reaction if you knocked rates down. That would affect the division of moneys between the rest of the UK, which would take its share of taxes on profits, and Scotland, which would gain only on the income tax.

The Convener: I have a couple of points to finish off with, before I let colleagues in. It is clearly the case that, the lower someone is down the income spectrum because of a lack of mobility, the easier it is to raise or cut their taxes with a surety of what the financial impact will be. I imagine that very few basic rate taxpayers would leave the country if their tax went up. They might not be happy about it, but they could not do anything about it. The situation would probably be similar for people in the middle part of the income spectrum. That money would, in effect, stay within the Scottish economy. If it was lost, there would be very little beneficial impact in terms of increased revenue, as folk are not going to move to Scotland because the basic rate has fallen or risen—is that correct?

Professor Bell: Certainly, migration would not be an issue. It would be a matter of basic work incentives and of how people responded in terms of traditional labour supply responses. Would they keep up their hours? Would some people drop out of the labour market? There are questions around whether people would take retirement at a different time and whether married women would drop out. In the past, they have been shown to be quite sensitive to tax rates.

There is then the question of what rates would be applied to the lowest earners—the people who are currently getting tax credits. You would have to do quite a complicated calculation to find out what rate they currently face and what rate they might face—depending on what happens with tax credits—if Scotland changed its tax rate. I do not think that migration would be an issue for that group, but you would have to be careful about changes in hours and possible withdrawals from the labour market.

12:15

There was an article by Martin Wolf in the *Financial Times* the other day, which was about the problems of the US labour market. It has a much higher drop-out rate than the labour market in the UK. At the moment, the UK has a very high level of participation in the labour market, even though a lot of people are earning relatively low amounts, but the US has not registered the same increased participation as the UK post the recession. Scotland currently has its highest-ever level of employment because participation rates are high. You want to be sure that any changes that you make towards the bottom end of the spectrum still leave people an incentive to participate in the labour market.

The Convener: In the last paragraph of your submission, you say:

> "there is a strong case for moving cautiously when considering changes to the higher rates of income tax in Scotland, even though there may be no evidence that they have a detrimental effect on rates of economic growth in the long run."

I find that quite interesting, because it is almost like saying that the economy will grow or not grow whether or not those people are here and paying tax. Is there an optimal level of taxation for high-rate taxpayers at which the economy can grow and we can optimise revenue without people fleeing the country?

Professor Bell: There has been a huge amount of literature on the optimal rate of tax, which was started by a member of the Council of Economic Advisers, Jim Mirrlees. I think that he won the Nobel prize on the basis of that work. There is a huge amount of work on the issue. I thought that I might attempt to do some work on the issue for my submission, but I did not get round to it.

Yes, there is an optimal level of tax, and I can send the committee some recent estimates that are quite a bit higher than some of the rates that are being levied at the moment in the UK. Looking at the long-run performance of economies, in my last statement—the one to which you refer—I was thinking about Scandinavia. The Scandinavian economies have had very high rates of income tax for a long time but have not fallen significantly behind the rest of Europe in economic growth.

The Convener: Stephen Boyd told us that tax revenues in Denmark are 12 or 13 per cent higher than here across the board and that that is borne by the population. However, surely, that is borne by the populations in Scandinavia because they have more left after tax—their incomes tend to be higher and they have more disposable income.

Professor Bell: Yes, that is true, but they also have a high standard of public services and people buy into the notion that that is part of the deal. It is a somewhat different culture from one in which people do not particularly value public services and are much more concerned about their personal consumption. It is really a cultural issue, and it is difficult to prejudge how that system might work in the UK. Countries such as Denmark do not appear to have suffered significantly in the long run from having higher rates, but we might get a reaction in the short term.

The Convener: Thank you. A number of members want to ask questions.

Richard Baker: I was on the Scotland Bill Committee much earlier in this parliamentary session, when we discussed the implications of the full devolution of income tax. There was quite a discussion about the potential for having a predatory tax policy, about cutting the tax rates in Scotland to attract high-income earners and about whether there would need to be agreement between the Treasury, the UK Government and the Scottish Government that such a policy would not be pursued. Does the fact that there has been no such agreement, similar to the ones that sometimes exist between states in America, not indicate that the received wisdom is that migration is not going to be an issue and that, if it is an issue, it will be marginal? Alternatively, do you think that those matters will be covered by the no-detriment policy that is outlined in the Scotland Bill?

Professor Bell: It is not clear to me how the no-detriment policy will cover all the ramifications of the effects on the other taxes that I mentioned: national insurance, VAT, corporation tax, excise duty and fuel duty.

I think that we are all guessing on the migration question. I would be more concerned about the long-term effect of not having people migrate to Scotland than about people emigrating from Scotland. That is my particular concern, and what matters is perception. It might be a general perception rather than one based on the detail of the additional rate being 47p rather than 45p, but if Scotland is perceived to be a high-tax jurisdiction and public benefits are not perceived to offset high taxes, there could be a negative effect. It is really difficult to predict.

Richard Baker: I accept that. However, in the European context, if we raised the additional rate to 47p rather than 45p, we would still be behind France, Germany, Denmark, Sweden and others. Surely, therefore, the impact would be marginal when compared with, for example, European migration, which has been important for Scotland over the past few years.

Professor Bell: Yes, but it is also true that, if you raised the rate to 47p, you would not raise a heck of a lot of additional revenue. That would be the downside, and that might well be the case. If you changed the amounts of revenue that are coming in through the Scottish rate of income tax, you would probably have to look a bit further down the income spectrum to make big hits.

Richard Baker: The answer to most questions about what would happen if we did X on tax seems to be that we do not really know. Do you think that enough modelling is being done on the potential impacts of various tax changes? I suppose that I am asking whether any such modelling is being done. Could more modelling be done to inform Government policy and public and parliamentary debate?

Professor Bell: That is a good question. I will say a little about that kind of modelling. The organisation that does most of that modelling is the Institute for Fiscal Studies, and we are doing some work with it just now. However, it talks mostly about short-run changes and focuses on the arithmetic effect of changes in taxes, which is reasonable. In the IFS's analysis of the budget, whether 3 million people will be worse or better off or whatever, the behavioural effects will not really kick in in the short run. It is not the case that everybody will emigrate before next year; it will take longer for the effects to be seen.

We have done a little work on behavioural responses, but it has been around a general area—for example, what would happen if we applied the Danish rates to Scotland. That is making a big jump and an assumption, so any result that we arrived at certainly could be debated and we would have to qualify it by asking whether it was applicable in the Scottish context.

There is a good argument for doing more work so that such issues can be debated, but there is another issue, which harks back to what was said in the previous evidence session. If you focus on the very top earners, you will find that there is not much information on that group. There are about 11,000 additional rate taxpayers in Scotland, and surveys do not tend to pick them up.

Doing the arithmetic calculations of the impact of taxes is difficult enough; modelling a behavioural response adds a further layer of difficulty. I am not saying that it would not be a good idea to try that, but the results would have to be heavily qualified.

Richard Baker: Thank you, Professor Bell.

John Mason: On page 2 of your submission, you talk about "elasticity of labour supply". I was struggling a little to get my head round that, especially the bit where you talk about what could happen if there was an increase in income tax. You say that that could cause

"real wages to fall by 1% and ... workers reduce their hours by 0.5%. Then the value of the elasticity of labour supply is 0.5".

Could you explain that?

Professor Bell: It is just a ratio. It is the ratio of the percentage change in the amount of labour supplied to the percentage change in the after-tax income of the individual. It is just a number; it does not have any dimension. Small numbers mean that there is not much of a response; large numbers mean high elasticity and a very marked response to changes in the tax rate.

John Mason: Right, but are you saying that if you increase income tax, less work will always get done?

Professor Bell: I quote a guy called Manski, who is a guru on economic policy in all kinds of areas. He says that there is no consistency on the estimates of elasticity that I have just described, but there is an agreement that if you increase tax rates, you will reduce taxable income.

John Mason: I presume that that is overall, because some individuals, in order to maintain their income, will do more work.

Professor Bell: Absolutely. The theory says that that is a perfectly plausible response to changes in tax rates. If you want to keep your real income up—if your income is what you really value—you will increase your hours of work. Some people do that but, on average, the findings have been that people reduce their hours. Of course, you can do that at what is called the intensive margin, which is hours of work, so you work fewer hours, or at the extensive margin, where you just drop out, so you do not supply any labour at all.

John Mason: In a slightly different context, you say on page 10 of your submission:

"Cultural acceptance of tax rate differences is probably country specific."

Are you arguing that there are quite a lot of differences between how people in one country—in Denmark, for example—and another country behave?

12:30

Professor Bell: Absolutely. You can see pretty significant differences across the US, Canada, Switzerland and Denmark. This harks back to earlier remarks about what the people in those countries are getting in return for their higher tax rates; perhaps they just take the view that there is a compensating differential with regard to the public services that are being offered. I guess that what I am saying is that we do not know the detail of that, so it is pretty difficult to take lessons from any of those countries and apply them to Scotland. However, it is worth noting that having differences in tax rates would not make Scotland unusual in the set of developed countries in the world, because differences in income tax rates are relatively common.

John Mason: Is the point that people's behaviour is not in a sense logical, or that the logic is different in different places?

Professor Bell: It is that there are differences in the costs and benefits in different places. What other taxes do people face? How do they respond to differences in indirect taxes? It does not necessarily prove that they are acting illogically, but they might respond to incentives in different ways or they might be facing other considerations such as differences in indirect taxes or the public services that are available to them.

John Mason: I know that this is a separate area, but I was struck by the 80 per cent drop in the use of bags as a result of the 5p bag tax. After all, people are paying £40 or £50 for their supermarket shopping, so why should they not want to pay 5p for a bag? In the scheme of things, that might seem illogical, but sometimes people react quite strongly to a very small thing, which I suppose might be the risk here.

Professor Bell: Yes. There are two modes of economic thought: the first is that people act logically all the time, and the second, which comes through the area of behavioural economics and might not have had the appreciation that it deserves, is that people are influenced by all kinds of things and might not act all the time in what might be their best interests. I should also say that the University of Stirling is particularly strong in behavioural economics.

I am not trying to suggest that people will behave logically or in their own best interests at every juncture; I am just saying that that adds to the complication of interpreting what happens in other countries. People might have a culture of working hard, and that might supersede the effect of changes in tax rates. Indeed, Manning found that, on the intensive margin, high earners do not change their hours of work much in response to changes in tax rates. In other words, if someone earns £500,000 a year and the tax rate goes up by 5 per cent, that person will still put the same amount of effort into their job, but they will also put more effort into finding and pursuing ways to avoid paying the higher tax. That might not seem logical, but the fairly uniform finding is that such people still maintain their work effort.

John Mason: I am finding it increasingly difficult to predict what might happen, but your suggestion that we proceed cautiously is probably good advice. Can we pin that down? If I were to say, "Let's increase the rate by 2p next April and see what happens," would that be proceeding cautiously?

Professor Bell: I guess so.

There is also the issue of signalling. For example, you might say, "Let's increase it by 5 per cent over five years." I think that that kind of behaviour would precipitate action around the tax avoidance behaviour, because I think that one of the things that happened in response to the announcement that the 50p rate would be taken down to 45p was that the announcement of the tax itself had an effect on behaviour.

John Mason: So it is about the signal that is sent out. For example, we could say that we will raise the rate by 2p in April and leave it sitting there for five years before we do anything else, but that would be different from saying that we will increase the rate by 1 per cent every year for five years.

Professor Bell: Absolutely.

Mark McDonald: Professor Bell, you mentioned people moving income into profit or dividend income in order to avoid paying income tax. You said that a change in the tax rate might encourage or discourage that behaviour. I presume that that would be true only if the tax that was then paid on that income was lower or the same as the rate that someone would pay if it was dividend income. How far do we need to go in order to encourage that kind of behaviour?

Professor Bell: People in a position where that matters are probably high earners who can pay for tax advice. As I said earlier, if we look at information about self-employed directors in a thing called the survey of personal income, we see that their pay tends to be bunched just below the £150,000 additional rate cut-off point. I take it from that that people who earn that kind of money have taken advice and have opted to pay corporation tax on the remainder of their income, whatever it might be. If the two rates were the same, there would be no incentive to do that and we would not see the bunching happening.

How much does the difference have to be? People in that position are offsetting the cost of the tax adviser whom they have to pay to give them advice about what to do. As long as they are ahead on the game, they will do that—for example, if they are earning £500,000, it is quite possibly worth their while to do it. Therefore, the issue is both the difference in rate between corporation tax and the top rate of income tax and how much above the top band of £150,000 their income is. If they are on £151,000, it does not matter.

Mark McDonald: There could also be tax variation at the other end, because although the personal allowance is not going to be devolved, there is talk of the Scottish Government having the ability to set a zero rate. I am not saying one way or the other that that would happen, but that is another way in which tax behaviour can be manipulated, for want of a better term.

Professor Bell: Yes, that is true and it raises an interesting point. Even if we do just the arithmetic calculations—the IFS-reaction-to-the-budget kind of calculations—it is really worth doing those, because if our concern is about poverty or inequality, say, changing the personal allowance might not necessarily have as big an effect as we might expect. That is partly because we usually look at issues such as poverty and inequality not on an individual basis but on a household basis, because it is households that are faced with the difficulty of putting food on the table or whatever. In that case what matters is whether there are two people in the household who would benefit from the increase in the personal allowance, or whether there is one person who is working and one person who is not working or a different combination—all those kinds of things are possible.

A very detailed calculation would need to be done to see whether that would benefit people when compared to, for example, reintroducing tax credits or compensating people for the loss of tax credits. Even without adding in behaviour, that kind of calculation is worth doing, because it gives the picture, as far as the household is concerned, on whether, by changing the personal allowance, we are moving people above the poverty line, which is 60 per cent of median household—as opposed to individual—income. I am not saying that it is one way or the other, or that it is not a good idea. I am sure that there are studies out there on how people will react to a change in the personal allowance, but there is always the problem of finding what the counterfactual is—what would have happened if people were not subject to an increase in the personal allowance.

Mark McDonald: We have spoken about the potential migratory impacts. In a population of just over 5 million, what qualifies as a significant behavioural impact? If the behaviour of only a small number of people is impacted, either positively or negatively, is that really a significant impact or, in thinking about the significance of the impact, do we have to take into account where those people are in terms of the amount of tax that they pay?

Professor Bell: Where people are is clearly important. It is for HMRC to make clear or to be able to accurately determine where people are in relation to their tax liabilities. From the news this morning, it is not clear that HMRC has been all that effective, for example, in pursuing people who have apparently been evading tax.

The short-run impact of migration might not be all that much. If the additional rate contributes about £700 million to Scottish revenues, it might not seem to be necessarily all that negative to lose some top earners, but we have to be careful, because those people might also be entrepreneurs and the fact that they move might have impacts on other parts of the economy. One of my big concerns about the Scottish economy over the past 20 years has been about the loss of decision-making power at the top end within Scotland. That certainly used to be there. The number of FTSE 100 companies that are located in Scotland has fallen over the years. I am fairly concerned about that.

In the longer run, for migration, one of the main differences when it comes to why the Scottish population will grow more slowly than that of the rest of the UK in the next 20 or 30 years is that we are forecast to have a lower level of net in-migration. Over time, that builds up. The fact that around 900,000 people were lost in the 1970s and 1980s has had a massive effect on the Scottish population. However, I am not saying that a change in the tax rates will reverse what has been a trend towards in-migration in Scotland in the past 12 or so years and particularly since 2004.

Migration is something that we have to be concerned about, but I do not think that the taxes that people pay is by any means the major issue as regards what determines the overall flows of migrants. That is perhaps more to do with public services, quality of life and so on.

12:45

Mark McDonald: Sure. I guess the question that I was driving at was, if we were to take the view that using the tax levels that we levy would attract people to Scotland or, on the flipside, drive people out of Scotland, at what point are the effects of that significant? How many people would we need to take in to be able to say that the policy had had a significant effect, or vice versa? Is there a model that we can look at that would indicate that, if we attract or lose 10,000 people on the basis of the policy, that would have a significant impact?

Professor Bell: I do not know that we have a model that does that. It would depend on what kind of people they were—what their average income was and, therefore, what kind of tax contribution they were making.

Clearly, if the Scottish economy is growing, migrants will be attracted into Scotland irrespective of tax rates, just because there will be employment opportunities in Scotland. There are plenty of people from around Europe who have already taken advantage of the employment opportunities that are available in Scotland and have moved in over the past decade or so.

Whether changes in tax rates would affect the overall pattern of migration is not entirely clear. We will not be able to do what the Danes have done and offer a specific rate to people coming in, but you have to be careful about losing, or not gaining, a group of high earners within the overall pattern of migration. There is movement, with significant gross migration flows each year, to

Scotland and from Scotland. The net difference is around 10,000 to 15,000 a year. That is roughly where we are with migration currently.

It seems unlikely to me that differences in tax rates would make a huge difference to that overall net flow, but you have to be concerned about whether the tax base or tax revenues, whichever way you want to look at it, are disproportionately affected by migrant flow.

Mark McDonald: On the question of how long you would need to be able to judge the impact accurately, one of the criticisms that has been levelled in relation to the 50p rate is that, because it was applied for only one year, in effect, it was not possible to judge its long-term behavioural impact. You can only really forestall the first year for which a policy comes into effect, but it might not affect those people who move towards taking profits. How long a period do you need to assess a tax change or a tax policy before you can accurately judge its impact?

Professor Bell: You would need at least three to five years, I would think, partly because you would not get the information on the overall revenues until about 18 months after the year end.

If we are talking about the self-employed, they complete their tax returns in January after the end of the tax year, then there is a bit of debate, so the accounts are not finished. Some of the debate around the 50p rate was being done in the dark, because that information was not available.

I think that you are right that it will take what I would call a medium-term perspective before we really know what is happening and what effect a change in taxes has had.

Jean Urquhart: I have a quick question about the evidence from what has already happened. In the early 1980s, we were paying 33p in the pound and, because of the political philosophy and policies of the time, that was changed over a few years until we reached the 22p or 23p in the pound that we pay now as a minimum. What evidence does that give? Can you refer me to anything about that? In a sense, that is hard evidence of what happens when, for whatever reason, income tax is reduced, whether or not we approve of that. I know that taxes went all sorts of other ways and there were changes elsewhere. Since then, every Government has been too nervous to change that approach.

Professor Bell: There was a considerable shift in tax policy in the 1980s, which is why looking at income tax on its own gives only a partial view of what is happening. High marginal tax rates were cut, but tax revenues did not fall all that much. There was an increase in indirect taxes—in VAT in particular—so the overall tax burden fell a bit, but not massively for the UK's economy as a whole.

Since then, Governments have continued to rely more on indirect taxes than on direct taxes. That is partly because collecting indirect taxes is easier than collecting direct taxes is. By indirect taxes, I mean VAT, excise duty, fuel duty and a few others. That has a distributional impact, because most people buy goods that are subject to VAT, pay fuel duty and pay excise duty on cigarettes and so on. In terms of real income, the shift towards indirect taxes tends to favour the rich relative to the poor.

That shift did not just happen in the UK. It was partly driven by the fact that collecting indirect taxes was easier than collecting direct taxes. The difficulty for the Scottish Government is that, in the UK, income tax has become sacrosanct. The increases in direct taxes in the past couple of decades have not really come through income tax; they have come through national insurance, which Scotland does not have the power to vary.

Reviews have been done of what has happened. The IFS has done that kind of work and I am happy to give the reference for that.

Jean Urquhart: Thank you—that is kind.

On the basis that, if tax rates increase, people work less, is there any evidence—again, we can go back to the 1980s and 1990s, when tax rates were reducing—that the converse is true? It is not true, is it?

Professor Bell: It is difficult to assess whether things work in reverse. The evidence—for example, on married women's participation—mostly comes from the 1980s, when there were big changes in income tax rates. The evidence that is out there, which is all subject to qualification, is that full-time males tend not to vary their labour input—their working time—very much in relation to tax rates; the same is true of single females. For married females, the position is a bit more doubtful. Of course, that might have changed. The rules that might have applied in the 1980s, or the observations that we have from then, might no longer apply because the nature of work has changed so much—for example, there is the ability to work at home, and people can put in their hours at home. I guess that I am saying that this is all quite difficult.

Gavin Brown: I have a couple of brief questions. You gave us the example of Denmark using tax rates to attract migrants—I think that the study was by Kleven et al. Do you have some idea of the magnitude of tax change that was used in that case?

Professor Bell: I have forgotten. It was fairly considerable, but the response was also pretty considerable. I know that the elasticity was about 1.52, which is very high, but I have forgotten what the initial change was. I will send that to you.

Gavin Brown: Thank you. The issue of the 45p to 50p rate has been raised a few times. You quote someone else in your submission, but you are basically saying that it is not possible to measure how much extra tax would be collected. What we know for sure is that the static costing will be wrong—that will not happen in practice. Having seen that happen and having seen the rate changed once in each direction, surely we must have some idea of the behavioural response that we would expect if it were to be raised again.

Professor Bell: I think that we should know that very soon. I was quite surprised that Manning's paper, which was produced just before the election, did not have the numbers for what actually happened and how much additional-rate tax was collected, but that information must be available.

Gavin Brown: In response to a question from Mark McDonald, you talked about being slightly cautious about playing around with tax rates too much, too quickly. You said that migration flows could remain the same in each direction, so we could end up with net migration being exactly the same with a changed tax rate. However, your point was that the composition of those flows could change.

Let us say that we put tax rates up dramatically. Are you saying that, while the overall numbers of people might remain broadly similar, lots of high-rate taxpayers might leave and lots of people who were not high-rate taxpayers might come in, which would lead to an impact on the public finances?

Professor Bell: The average age of migrants out of Scotland tends to be lower than the average age of in-migrants. The young leave Scotland and people who are on average a bit older—though not much—come back. In-migration is made up of quite a lot of young migrants coming to Scotland and also people retiring to Scotland. As you say, the proportion of that group that is responding to changes in tax rates is quite important, because that will affect the demand for public services and the revenues that the Scottish Government collects.

Gavin Brown: That is helpful.

13:00

The Convener: I have one final point before we wind up. Paragraph 7 of Gavin McEwen's paper refers to a study by McGuire and Rueben that found that

"how spending is correspondingly reduced matters. Thus tax cuts leading to reduced spending on services which impact on business, such as education, may have an offsetting effect on business location and economic growth."

In paragraph 11, Gavin McEwen says that the general conclusion is that

"States wishing to foster entrepreneurship should focus on creating a stronger business climate and economic growth rather than on tax policies."

That is saying that reducing taxes can have a detrimental effect but that taxes overall—again, I refer to the point that you made in the last paragraph of your submission—do not necessarily affect overall long-term economic growth.

Professor Bell: That is probably true. Tax is one consideration among many when someone is thinking about locating their business. I have a small amount of evidence that suggests that companies think pretty carefully about, for example, moving people around. An international organisation will have people working for it in different parts of the world. Some companies are already thinking about how they might compensate employees if higher tax rates are levied in Scotland or, I guess, how they might pay employees less if taxes are lower in Scotland. Some companies are thinking about such tax planning.

When it comes to locating a business, a company will assess how important it is for its particular type of employee to have a lower or higher rate of tax and may make compensating adjustments. However, it will then look at all the other costs and benefits that are associated with the jurisdiction that it is thinking of moving to. In Scotland's case, that would include free education, free health services and all the other public services.

The Convener: Do you have any further points before we wind up the session?

Professor Bell: No—that is it.

The Convener: Thank you very much for your responses and your submission. I thank Gavin McEwen, too, for the excellent paper that he produced.

13:02

Meeting continued in private until 13:15.

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