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Pàrlamaid na h-Alba

Official Report

DEVOLUTION (FURTHER POWERS) COMMITTEE

Thursday 14 January 2016

Session 4

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DEVOLUTION (FURTHER POWERS) COMMITTEE

2nd Meeting 2016, Session 4

CONVENER

*Bruce Crawford (Stirling) (SNP)

DEPUTY CONVENER

Duncan McNeil (Greenock and Inverclyde) (Lab)

COMMITTEE MEMBERS

*Malcolm Chisholm (Edinburgh Northern and Leith) (Lab)
*Linda Fabiani (East Kilbride) (SNP)
*Rob Gibson (Caithness, Sutherland and Ross) (SNP)
*Alex Johnstone (North East Scotland) (Con)
*Alison Johnstone (Lothian) (Green)
*Stewart Maxwell (West Scotland) (SNP)
*Mark McDonald (Aberdeen Donside) (SNP)
*Stuart McMillan (West Scotland) (SNP)
*Tavish Scott (Shetland Islands) (LD)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Dr Monique Ebell (National Institute of Economic and Social Research)
Professor David Heald (University of Glasgow)
David Phillips (Institute for Fiscal Studies)

CLERK TO THE COMMITTEE

Stephen Imrie

LOCATION

The Mary Fairfax Somerville Room (CR2)

Scottish Parliament

Devolution (Further Powers) Committee

Thursday 14 January 2016

[The Convener opened the meeting at 09:30]

Fiscal Framework

The Convener (Bruce Crawford): Good morning colleagues and witnesses and welcome to the second meeting in 2016 of the Devolution (Further Powers) Committee. I remind members to switch off their phones or at least put them on silent.

Item 1 is evidence on Scotland's fiscal framework. Our witnesses this morning are Dr Monique Ebell, research fellow at the National Institute of Economic and Social Research, Professor David Heald, professor of public sector accounting at the University of Glasgow, and David Phillips, senior research economist from the Institute for Fiscal Studies, who has a bit of a cold, so we will try not to be too hard on him.

I know that you have all come quite a long way to give evidence today and we are grateful for that. Our evidence session will be short, probably lasting just over an hour, so I propose that we get straight into the guts of the real issues, rather than asking general opening questions.

I will begin with block grant adjustment issues and indexations. Mr Phillips, on page 30 of your submission you say that over the period 1999 to 2013, depending on the indexation method used, Scotland could be either £1.5 billion—or roughly 5 per cent of the Scottish Government's current budget—better or worse off if we had been using the new powers from some time ago. In your view, which indexation method provides the best outcome for Scotland's budget and what reasons do you have for that choice? What would represent a fair and sustainable deal for Scotland? Forgive me if those are big questions for a man who is feeling a wee bit under the weather.

David Phillips (Institute for Fiscal Studies): On which method would tend to give the most generous budget settlement to Scotland, our analysis suggests that that would be the per capita indexed deduction—PCID—method in which you take the block grant adjustment in year 1 and increase it by the per capita revenue growth in the equivalent taxes in the rest of the United Kingdom. That offers more generous funding for Scotland than the other two methods because it takes account of population growth. Scotland's population grows more slowly on average than that of the rest of the UK, so if you are trying to compare Scotland's revenue growth to the aggregate growth in the rest of the UK and do not take account of the population growth, revenues per capita in Scotland would have to grow more quickly to keep up because of the population growth in the rest of the UK. By taking that into account, the PCID method is a bit more generous to Scotland.

We have called the other method that we consider in our paper the levels deduction method. It increases the block grant adjustment every year by the population share of the change in revenues of the rest of the UK. We chose to examine that method because it mirrors the Barnett formula, which allocates a population share of the change in spending in the rest of the UK. That method is less generous to Scotland than PCID because revenues per capita in Scotland start off lower.

For example, if revenues go up by £10 billion in England, that might be a 7 per cent increase. Scotland's population share of that £10 billion is about 10 per cent, which is £1 billion. However, £1 billion growth in Scotland would not be 7 per cent growth, but would be more like 9 per cent, because revenues started off lower. Under the levels deduction approach, you need revenues in Scotland to grow more quickly in percentage terms to keep up with the block grant adjustment, which goes up on a cash terms basis.

The method that gives the most generous funding to Scotland under current conditions, where there is relatively slow population growth and lower revenues per capita to start with, is per capita indexed deduction.

Then there is the question of what is fair, which depends on what you think the degree of risk sharing and equalisation should be across the UK. If you think that the no-detriment principle means that you would not want to design a system that would lead to the unwinding of any redistribution that currently exists between Scotland and the rest of the UK, you would want to choose a system that keeps that level of redistribution built in. That might mean that if revenues go up by the same percentage points per capita—for example, revenues grow 5 per cent per person in England and Scotland—you might think that the Scottish budget would be the same as it would have been without devolution because revenues are growing at the same rate per person and Scotland is performing as well as the rest of the UK. You would want to choose PCID in that case.

On the other hand, if you thought that devolution of a tax meant that it was no longer right to redistribute that tax across the whole UK and that future extra tax revenues raised in England should not be partly transferred to Scotland, you would want to choose the levels deduction approach. That approach means that revenues raised in England stay in England, and revenues raised in Scotland stay in Scotland.

The PCID approach means that there would be some transfer of revenues from England in future years to Scotland, so it is clear what is better for Scotland in terms of the amount of budget, but what is fair depends on your view on whether there should be continuing redistribution of income tax around the UK.

Professor David Heald (University of Glasgow): The committee has on its website evidence of modelling by David Eiser from the University of Stirling and Anton Muscatelli from the University of Glasgow. It is pretty obvious from that modelling that it is the per capita indexation method that meets the idea that the act of devolving tax powers is not going to be disadvantageous to Scotland.

I therefore support the per capita indexation method. However, the bigger point is that there is a lot of technical-sounding argument about what is, in essence, a political point. If you read the Holtham commission report and the House of Lords Economic Affairs Committee report, you will see that it is obvious that they think that Scotland gets too much money, but in the political context after the Scottish independence referendum, the Smith commission was supposed to do good things for Scotland. There is an obvious clash of political expectations there.

I emphasise that it is important that the actual act of tax devolution does not, through the indexation method, damage the Scottish position. If you want to argue about whether Scotland is overfunded relative to Wales, for example, you should argue that point explicitly. If you link through technical things that virtually nobody understands a reduction in the Scottish budget to how the indexation works, I think that you will discredit the tax devolution.

David Phillips: I agree with that point. There is a discussion to be had about the indexation method. However, if the levels deduction method was used to sneak in extra convergence through the back door, that would be damaging for the fiscal framework in the UK and it would be a bad idea. If you want to deal with that issue, you need to deal with it directly.

Dr Monique Ebell (National Institute of Economic and Social Research): I would like to take a step back from politics and a step towards economics for a moment. If it is the case that the PCID method redistributes a bit more, particularly over the business cycle, the Scottish Parliament should take that into account. One of the issues around devolution is a potential lack of risk sharing across the UK. It is possible that the Scottish Parliament would like to preserve some of that risk sharing, particularly over the cycle. If the oil price drops and unemployment rises here in Scotland, you would not want to be forced into a sort of pro-cyclical austerity politics at a time when you are facing difficult economic conditions. One of the ways in which you can guard against that is to ensure that there is still some redistributive element across the entire UK. An argument could therefore be made for having such macroeconomic stability and automatic stabilisers to ensure that you would not be pushed into austerity in bad times.

David Phillips: I want to come back in on that last point. All the methods—levels deduction, indexed deduction and per capita indexed deduction—offer risk sharing, at least to a degree, on shocks that affect the whole UK. If revenues fall in the rest of the UK, the block grant reduction will shrink, which will offset any falls in Scottish tax revenues. There is a risk insurance against shocks that hit the whole UK, but none of the methods that have been outlined offers any insurance against shocks that hit Scotland only.

That has been missing from the devolution debate. The Smith commission said that the UK Government should bear any shocks that hit the whole UK and that any gains and losses resulting from policies should be borne by the relevant Government. However, it did not say who should bear the risk of shocks that hit Scotland alone or that hit Scotland disproportionately, such as oil price shocks. There needs to be a discussion about whether there should be some way of risk sharing shocks such as the oil price shock.

The Convener: We will come on to issues to do with borrowing and how it might be used to deal with shocks and for stabilisation. However, before we get there, I have another question. The PCID method might be the best for Scotland, but what will the Treasury's view of that be?

Professor Heald: That depends on whether the Treasury wants to keep the present mechanism. There are political constraints post-referendum and post-Smith commission. One of the attractions of the Barnett mechanism for the Treasury is that it basically avoids a lot of bilateral negotiation with Scotland, Wales and Northern Ireland about things that the Treasury does not actually know enough about to be an effective negotiator. The Treasury has to worry only about English and UK programmes, and the Barnett consequentials of those are automatic.

The great advantage of Barnett for the devolved Administrations is that it keeps the Treasury off their individual budget lines. The Treasury cannot disallow certain expenditure because it disapproves of it. That goes back to George

Younger in 1980. The expenditure-switching discretion formalised something that had been much more informal before that, and it was one of the great powers of secretaries of state after 1980. It has been one of the great powers of the Scottish Parliament. There are bureaucratic and technical advantages for the Treasury in keeping the system working.

However, there is a big political issue about whether people want the United Kingdom to survive. How people will judge the success of the fiscal framework depends on what they expect of it. If the fiscal framework is seen as an attempt to bash the jocks because they had the cheek to ask for an independence referendum, or if it is seen as a way of getting more grievances to justify another independence referendum, it will not work.

If we want the system to work, it seems to me that there are advantages in not linking indexation adjustment to the question whether Scotland gets too much money. One point about Barnett is that it has a convergence property but, because of the lack of data, it is difficult to establish how far convergence has gone. The Treasury spent 25 years pretending not to understand parliamentary questions and freedom of information requests asking for comparable expenditure. The level of ignorance is demonstrated by the fact that the House of Lords quotes identifiable expenditure as though that was solely driven by Barnett.

The Convener: Do you want to comment, Dr Ebell?

Dr Ebell: No. I will defer to my colleagues on Barnett issues, but I will speak up quite a bit about borrowing.

The Convener: Mr Phillips, do you want to comment on the Treasury?

David Phillips: The Scottish Government has been clear on its position: Swinney has said that Scotland wants the per capita indexation deduction method. We know that the block grant adjustment issue is one of the sticking points in the negotiation. It has been highlighted in media stories about the issue. It is likely that the Treasury is asking for different things. What facts might be driving the Treasury's thinking? Professor Heald mentioned that the Treasury quite likes the Barnett formula methodology. The Treasury might be looking for more consistency with the Barnett formula, which points us towards the levels deduction approach, which is the one that we have shown is least advantageous to Scotland in the short run.

09:45

The Treasury might also be thinking about devolving taxes in the same way as has been done with business rates. You might have noticed that the way in which business rates have been accounted for under the Barnett formula changed during the latest spending review period. The Treasury has done that according to a levels deduction approach, which might indicate its thinking on other taxes.

However, the Treasury might be thinking differently. Whereas the Scottish Government might be more concerned about potential long-run divergences in funding resulting from the levels deduction approach, under which you need to get revenues growing quicker each year so as to keep up with the block grant adjustment, the Treasury might be more concerned with the fact that, under the per capita indexation method, if income tax in England is increased by a percentage point so that more can be spent on the national health service there, for example, the way in which that will work through the whole system means that Scotland will get a population share of that extra funding under the Barnett formula. If revenue goes up by £10 billion in England, Scotland will get £1 billion and the block grant adjustment will go up by 7 per cent, which is an £800 million increase in Scotland. The net effect of those two things is that Scotland's budget goes up by £200 million following a tax increase in the rest of the UK, because the PCID method does not quite line up with the Barnett formula. The Treasury will be concerned about the politics of that in England.

I do not know any privileged information about this, but it is likely that the Treasury is moving towards a different system from what the Scottish Government is doing because of the differences in incentives that it faces and because of the differences in the budgetary consequences.

Professor Heald is right to think about the long-term consequences. The Treasury might be facing difficult decisions about what it thinks is the most fair system and what it thinks is the most politically sustainable system in the union.

The Treasury might not wish to adopt the PCID method because it thinks that the Scottish Government will not accept a disadvantageous method. It is in quite a difficult position when it comes to knowing what to do.

Professor Heald: The most important point regarding the discussions is that the system must be made transparent. You cannot have a debate about fairness unless the proper data are in the public domain. I have already made a point about the publication of comparable expenditure in England, which drives the Scottish block, and the different comparable expenditures for Wales and Northern Ireland.

There is another good example. It became Treasury practice to publish a new version of the funding policy document at the time of every spending review. The Treasury just decided not to publish it at the 2013 and 2015 spending reviews. It is absolutely essential, particularly when devolved Administrations and the UK Government are under different political control, that the numbers are put in the public domain at the right time. One obviously expects Governments to negotiate privately but, when the deal is done, the full statistical information ought to be put into the public domain immediately; it should not depend on people such as me submitting freedom of information requests to try and get it months later.

Mark McDonald (Aberdeen Donside) (SNP): I was intrigued by the idea that the drop in oil price and the resultant unemployment would be a shock borne by Scotland alone in this context, given that the revenues accrue to the Treasury and that there would also be employment implications outwith Scotland as a result.

Leaving that aside, I note that the command paper says:

> "the fiscal framework must require Scotland to contribute proportionally to fiscal consolidation at the pace set out by the UK Government".

Monique Ebell has spoken about not being forced into a position of austerity, but that is very much the language—"You are going to be tied into austerity by this, whether you like it or not." At least, the UK Government is giving that indication in its command paper, is it not?

Professor Heald: There is obviously a paradox there. A few minutes ago, I was talking about the convergence properties of the Barnett formula but, if public spending is cut, the Barnett formula has a divergence property, not a convergence property.

Coming back to the premise of your question, one has to recognise that it is not just oil revenues that come from the oil sector. Clearly, significant income tax and VAT revenues come from people employed in the oil sector.

I turn to the question of how much risk the Scottish Government should take in the context of Scotland remaining part of the United Kingdom. There is a lot of talk about giving Governments incentives for growth. Quite a lot of that is to do with the revolt of the rich, who do not want to pay into the equalisation system any more. The point is that the key economic levers will remain with the United Kingdom Government, and I think that that is where most of the risk should stay.

Dr Ebell: The point that I was trying to make about a shock hitting Scotland perhaps a bit unequally compared with the rest of the UK was about automatic stabilisers. From looking at the way in which federations work in other countries, such as the US and Switzerland, where they work quite well, we know that the social security system is one of the things that tend to be maintained centrally—I am talking about things such as welfare spending, unemployment insurance and pensions—because the risks should be pooled across the entire country. Leaving the social security system as a UK-wide system offers some stability to Scotland if it is hit by a shock that the rest of the UK might not be hit by, such as a reduction in the oil price that leads to job losses in the oil and gas sector in Scotland. Indeed, the rest of the UK might benefit from the drop in the oil price in other ways.

There is a question about exactly which types of spending should be devolved and which types should remain centralised.

David Phillips: There are two kinds of borrowing or fiscal stances that the committee might want to think about. Maybe the statement in the command paper focuses on one of them. The first relates to a shock that hits Scotland that requires temporary borrowing because of lower revenues in Scotland and the oil industry suffering. Scotland would need the capability to borrow to smooth that shock. If the statement was meant to suggest that that was not possible—that, if the UK was in a good position and was trying not to borrow, Scotland should not borrow—that would be damaging to Scotland.

Mark McDonald: I would like to come in on that. Obviously, the chancellor's fiscal mandate puts him towards a position of zero borrowing. There is a question mark about whether that will be implicit in the fiscal framework. Essentially, Scotland would therefore have borrowing power but would be constrained due to the fiscal framework and the UK fiscal mandate to not be able to borrow.

Dr Ebell: It is not quite clear at present to what extent Scotland's borrowing will count in the fiscal framework. Let us think about Scotland's borrowing being treated in the same way that local authority borrowing is treated. Together with central Government borrowing, local authority borrowing is a component of the Government's target public sector net debt figure or public sector net borrowing figure. It is also a component of the Maastricht debt criteria. Currently, the institutional bias might well be towards treating Scottish debt in the same way that local authority debt is treated.

There is a case for not considering sub-national debt as part of the UK's fiscal framework. It would make sense from an economic perspective to treat Scottish debt as part of the overall UK fiscal framework mandate if there were either an explicit or a strong implicit guarantee by the UK Government on that debt. Whether Scottish debt should be a part of the UK's fiscal framework and the goals that the Treasury sets for itself should depend on the extent to which that debt is an obligation—either explicit or implicit—of the UK Government.

Mark McDonald: I probably know the answer to this question, but do we have any indication of the Treasury's thinking on how it might categorise Scottish borrowing? I see shakes of the head.

The Convener: That is a no.

Professor Heald: I am not speaking for the Treasury, but I think that it would be astonishing if the Treasury were to agree not to include Scottish borrowing. There are two issues: one is the United Kingdom's European Union obligations under Maastricht and the European system of accounts, and the other is the International Monetary Fund's article IV fiscal consultations on the United Kingdom. I would have thought that an attempt to park Scottish borrowing somewhere separately and pretend that it was not there would not work. For example, in a country as fiscally centralised historically as the United Kingdom, if people said that there was a no-bailout clause, frankly I do not think that anybody would believe it.

Mark McDonald: I have a final question.

The Convener: It must be very brief.

Mark McDonald: Where the line is drawn for when the indexation begins will be important on both sides. The likelihood is that it will probably be 2017-18. Based on the fiscal projections, will that be a good year zero for Scotland?

David Phillips: The command paper suggests that we might want to take an average over several years to get the base year for the indexation. It is not clear whether we will take just 2017-18 or take an average over—say—three or four years before that.

Whether that is a good period depends on whether you think that 2017-18 will be a year when Scottish revenues are relatively high or relatively low compared to those in the rest of the UK. For example, if you think that the problems in the North Sea mean that income tax and VAT receipts would be temporarily low in Scotland in 2017, you would lock that in and have it as the base year. If and when there is a recovery in the North Sea sector and that boosts revenues, Scotland would get to keep those revenues, because you would have locked yourself in from a low starting point. You would get to keep the upside.

On the other hand, if you think that most of the pain in the North Sea is still to come because it will take a while for the sector to wind down, you might start at a relatively high point and the trajectory would be downwards from there. You are right to say that the starting point matters.

I come back to the point that I made at the start of the meeting. There has not been a discussion about what degree of risk sharing there should be on shocks that hit Scotland disproportionately, whether they are short-term shocks or long-term secular declines or improvements. Most other states with substantial sub-national devolution have some kind of equalisation of such differential trends over time. Germany, Canada and Australia all have it. The UK will not have that kind of thing, and that makes things such as starting points much more important.

Professor Heald: As I made the argument for per capita indexation, I should say that gaming the starting point would be very foolish on either the Treasury's side or the Scottish Government's side. People tended to assume 18 months ago that the base year would not be that important but, given what has happened to the oil sector, it may well be important. We know from the transition to land and buildings transaction tax that substantial forestalling can take place. This is obviously a difficult area and I would want to try to get a verdict that is as neutral as possible, because there are questions about the legitimacy of the system. If the system is seen to be illegitimate on either side, frankly I do not think that it will survive.

The Convener: We have begun to stray into borrowing, so I think that we should go to Alison Johnstone, who has a question on borrowing—I know that Linda Fabiani had a supplementary question.

Alison Johnstone (Lothian) (Green): I would be interested to hear the panel's views on borrowing. Borrowing can obviously help in cases of shock, forecast errors and volatility. It can also help us invest in opportunities to build employment, infrastructure and so on. What do you think an optimal borrowing framework would look like? What level of borrowing powers would be appropriate for this particular Scotland Bill?

I believe that David Phillips, in response to Mark McDonald's question, indicated that he thinks that having to contribute to UK fiscal consolidation would constrain and compromise the policy autonomy of the Parliament and Government. I would be interested in Dr Ebell and Professor Heald's views on that, too.

10:00

Dr Ebell: The issue of Scotland and borrowing powers is a bit tricky, because the set-up here is very different from the way in which other federated countries are set up. The US and Switzerland, along with Canada, are perhaps the most successful and well-functioning examples. In those cases there are, respectively, 50 states, 26 cantons and 14 provinces of roughly equal size. In

Scotland, we have one quite small sub-national unit and the rest of the country, with two even smaller sub-national units. That presents a different set of incentive problems with regard to borrowing and the credibility of no-bailout clauses.

Borrowing can be very beneficial in smoothing out shocks over the business cycle, and setting the right incentives can play a very important role in accountability. If Scotland would like to invest in order to create jobs and promote growth, it would, by borrowing, in some sense be putting its money where its mouth is and ensuring that it takes the decisions that will lead to growth because it will need to pay back the money that it has borrowed. That guards against—if I can be North Korean for a moment—putting up big statues to the dear leader on borrowed money.

That works, however, only to the extent that there is not a bailout promise, be it explicit or implicit, from the central Government. I like to use the example of my three teenagers at home. If one of them were to exceed their borrowing limits—if they downloaded too many videos abroad, which gets expensive, and exceeded the limit on their mobile phone contract—I might be tempted to bail them out, but if I did, the other two would come running and say, "Hey, wait a minute!" It would set a very bad precedent, as the other two would start downloading irresponsibly and running up big bills too.

That is close to the situation in Swiss cantons and in the US states. There have never been bailouts of cantons or states that have gone into debt. California is a perennial difficult case, and the canton of Berne was in serious financial difficulties and was not bailed out. In the UK, we are looking at a slightly different situation in which we would really only have the one sub-national unit—or potentially two, if Wales gets similar powers—that is quite small. That would tend to raise an only-child problem, as you tend to be more generous with an only child. Sorry—I do not mean to infantilise the situation; I hope that nobody takes that example in the wrong way. I realise that it has a big pitfall that was not intended.

If there is only one subnational unit that is borrowing, the temptation to bail out might be quite a bit larger. I would imagine that the optimal fiscal framework depends not only on Scotland but on how the rest of the UK deals with its own devolution issues, and whether the Government is serious about initiatives such as the northern powerhouse.

Professor Heald: One of the points here is that economists tend to talk in terms of the cyclical reasons and the differential cycle reasons for wanting borrowing powers. Clearly, if you have more devolved tax powers, you need more borrowing powers for smoothing purposes. However, what worries me in the post-referendum situation, is that people seem to think that tax powers mean more spend, and that devolving welfare powers means more welfare spend. I am sure that the argument will arise and that people will want to use borrowing powers to offset the UK Government's austerity agenda.

In 1976, when I first proposed what became the tartan tax, one assumed that there was not that much difference between what a devolved Administration in Scotland, Wales or Northern Ireland would want to do and what the UK Government would want to do. However, when you get a UK agenda about shrinking the state that the devolved Administrations do not share, you get a big gulf. It would be difficult to use tax powers to offset the shrink-the-state agenda. Any notion that you could use borrowing to offset that agenda is extremely dangerous.

The idea that there can be no control on borrowing is fallacious. There have to be controls on borrowing. I am open-minded as to what the mechanisms are, but there is no way that I would favour uncontrolled borrowing internally or in terms of the UK's international obligations.

David Phillips: The level of borrowing powers will have to be substantially increased, especially from the current powers, which are really quite constrained. Scotland can use them only for forecast errors but, if you forecast a recession, you might still want to borrow to smooth the impact of it on public spending. Therefore, there will need to be a change in the level of borrowing powers and the type of circumstances in which those powers can be used.

With my colleagues David Bell and David Eiser, I will do a paper that will try to quantify how big the borrowing powers need to be, given the potential volatility and risk in the Scottish budget with all the new powers. We will try to get a number for the committee to say whether, for instance, £3 billion, £5 billion or £10 billion of borrowing powers will be enough.

There is also the question whether the UK Government will be willing to allow Scotland borrowing powers not only to smooth the cycle but to pursue a longer-term differential fiscal stance. Rather than having a surplus in normal times, the Scottish Government might say that it wants to borrow 1 per cent of gross domestic product in normal times because it thinks that that is sustainable. There is less chance of the UK Government acquiescing to that because it would be seen as not only giving Scotland the powers to manage its risk but allowing it to take a longer-term fiscal stance that is different from the UK's with the implicit backstop of the UK being there to bail it out. What the UK Government agrees to do on borrowing powers might depend on the extent to which the idea of there being no bailout is considered credible.

The capital side is another issue. There has been debate about whether there should be some kind of extended capital limit or prudential borrowing powers. I am not sure what the right answer is on that. It has often been said that prudential borrowing powers have worked well for local government. That is the case, but it is not clear that that would necessarily be the case for the Scottish Government, given that the situation involves different political issues, such as bailout and central Government taking control if it thinks that there has been unprudential borrowing. There is a good case to say that the Scottish Government should have prudential borrowing powers, but I can imagine the Treasury being more reluctant to grant those powers because, although it can override local government prudential borrowing powers if it turns out that they go badly, there is no way that it can do that with Scotland.

Dr Ebell: The way that I would think about that comes back to the credibility of the no-bailout clause. It is a big if whether it is possible for the Treasury credibly to commit to not bailing out. We know from the experience of other countries that the market mechanisms in countries with credible no-bailout promises work well in the sense that, if a sub-national unit such as a Swiss canton or a US state overborrows, it will find itself punished with higher interest rates. In that sense, the mechanism works well.

In fact, it works so well that many Swiss cantons and the majority of US states have self-imposed fiscal rules, such as a requirement to balance the budget over the cycle or a golden rule that involves some sort of net fiscal balance, but setting aside investment. When there is a credible bailout promise or no-bailout promise, the market mechanism works well. In fact, it works so well that some national units find it to their advantage to signal to the market that they are prudent by imposing a fiscal rule of some sort on themselves. The big question is, will it be possible to set up such a credible no-bailout framework?

Stuart McMillan (West Scotland) (SNP): Alison Johnstone asked a couple of the questions that I was going to ask.

Dr Ebell talked about federated countries. The UK is not a federated country, regardless of the powers that are to come to Scotland. Further, as the devolution agreements are not standardised, there are various levels of devolution among the four nations in the UK.

The issue of the northern powerhouse has been touched on with regard to the positive effect that that agenda might have on the north of England, but there are still questions about the levels of powers that will go along with that.

I have listened to everything that has been said, but I am a bit confused about the starting point that you are taking with regard to the levels of powers and the constitutional position of the four nations.

Dr Ebell: As I said at the outset, this is a tricky discussion, simply because it is an atypical case. Usually, countries with sub-national units that have the kind of revenue-raising and expenditure powers that Scotland is set to receive involve many similar units in a federated country. A country with a similarly asymmetric devolution framework is Spain. I am not sure that, given the recent difficulties in Spain, especially around sub-national borrowing, we would want to take its framework as any sort of guide.

Stuart McMillan: Sorry for interrupting, but the various states in the USA are all different shapes and sizes and have various levels of population, too.

Dr Ebell: Yes, but there are many of them. Each one is small relative to the whole. Further, the federal Government also understands that it is facing 50 states and, if it gives in to one, there is a risk that the others will come calling, too. That risk does not exist in the same way in the UK, and that is important.

A recent IMF study showed that those federated countries in which the revenue-raising and the expenditure powers are closely matched—that is, those countries in which the sub-national units rely mainly not on transfers but on their own ability to raise taxes and borrow—tend to perform better. Examples of such countries include the US, Canada and Switzerland, primarily. I am sorry to harp on about credibility, but one reason for that might be that the fact that there is a small transfer dependence makes the no-bailout clause more credible.

Again, to go back to my teenager example, if my teenager overspends but I can say, “You can do some babysitting or use your overdraft,” I am also much more able to say no to a bailout. That is an important point, too.

10:15

Professor Heald: I will return to the premise of your question. My view is that the UK is very dysfunctional. If you look at where the big hits on fiscal consolidation at UK level have gone, they have gone heavily to local government in England and there has been a massive removal of redistribution within the local government finance system within England.

If you look at the hits that the northern and Midlands industrial cities have had, you will see the extent of that. The northern powerhouse is largely a political cover for the damage that has been done within England. The area of London and the south-east is increasingly dominant within the UK and it is the net recipient of much of the immigration into the UK, meaning that the population trend factors become more important and the rest of the UK has been writing implicit guarantees to the financial sector.

If you do a thought experiment about what the regional impact would have been of the UK letting the banking and financial sector collapse in 2008, clearly, there would have been massive hits for London and the south-east. The fiscal repair from that damage has largely hit other parts of the UK, particularly the north and the Midlands.

One thing that really worries me—it is a fundamental point for this Parliament—is that given the strange asymmetric animal that the UK is, there is a natural alliance between Scotland, Wales and Northern Ireland as regards having some kind of agreed position in relation to the UK Government and the Treasury. One thing that has happened over the past 10 years is that we have lost Wales. Wales is often associated with attacks on the Scottish position.

That is partly attributable to the fact that the Labour Government at the UK level did not make an effort to sustain the Barnett system. In 2002, Alasdair McLeod and I published an Institute for Public Policy Research book chapter in which we explained what the then problems with Barnett were and what could be done to assuage fears in Wales and Northern Ireland about it, but nothing was done. There was plenty of money around and people did not worry very much about it. One is now seeing the consequences.

We cannot discuss Scotland without thinking about the broader context of the UK's regional dysfunctionality.

The Convener: We need to move on to welfare.

Malcolm Chisholm (Edinburgh Northern and Leith) (Lab): Most of the discussion of the block grant adjustment has been in relation to tax powers, particularly income tax, but obviously there are completely different issues with welfare. I would welcome your thoughts on the initial allocation of money to welfare—which may not be quite so controversial—and then on the block grant adjustment and to what extent that is complicated or made different by the fact that welfare is under annually managed expenditure rather than under the departmental expenditure limit expenditure that we are used to.

David Phillips: I think that having welfare under AME as opposed to DEL makes it somewhat easier. You can think of tax as being like AME as well; tax is like AME in the same way as welfare is like AME. You do not know what you are going to raise or spend in a particular year until you have done it. It is not like a DEL, which is fixed in advance. I do not think that there are any particular issues with welfare being AME in terms of the block grant additions and how we index those, because we have the same issues with taxation.

I am not entirely convinced that there should be a separate or more complicated way of indexing the block grant additions for welfare than there is of indexing for tax. In tax, people have focused on two or three relatively simple methods—for example, the per capita indexation method and the levels deduction method. There have been discussions about welfare being not just about population but about the characteristics of the population. In particular with disability benefits, it is about the population who are at risk—the older and the less-healthy population—so the argument is that we should have an indexation method that accounts for that. In principle, that seems to be plausible. In practice, though, it could be difficult. It might be simpler and more transparent to go with a more basic approach, such as per capita indexation. I will explain why.

You could think about making an adjustment in the first year and saying, "Okay, we know what the distribution of disability benefit spending is across ages in year 1. We can track the population over time by those age groups and adjust on that basis." However, there have been big shifts in how disability benefits are spent among different age groups; in the past 20 years, there have been big falls among older people and increases among younger people. If you do not account for that, you get allocations that do not reflect who requires disability benefit spending. If you try to account for that, though, you end up with a complicated system in which you are changing the indexation method every year, which would require constant renegotiation and would violate one of the other principles of the Smith commission.

Further, if you are taking account not only of age but of the health of the population, you are removing one of the main incentive effects—one of the main benefits—that has been discussed in this regard. When devolution of disability benefits has been discussed in the past, it has been in the context of integrating those benefits better with our health and social care services. If we do better on health and social care, which means less ill health, we reap the rewards in lower benefits spending and having more to spend. We can shift that money over to other areas of priority. If you adjust for those health trends, you will remove the benefit of devolving the powers, because health is improving in Scotland and a more healthy population would mean that Scotland would receive less money for welfare.

You do not, therefore, want to remove the incentive effects. My feeling is that you should stick with something more simple—for example, the methods that are being discussed for tax. That will do a reasonably good job. You might, in principle, have to do a bit better with other methods, but there are trade-offs in terms of complexity or removing incentives.

Dr Ebell: I tend to agree with David Phillips that incentives are important, but I would perhaps take a slightly more nuanced view. I will use another example from abroad. You may be familiar with Detroit, which has recently filed for bankruptcy. The main reason is that Detroit found itself in secular decline, along with the auto industry. It had a large number of pensioners and the incumbent pension and healthcare costs, which were locally financed. It found itself with rising costs for pensions and healthcare and a shrinking tax base, which put Detroit into quite a downward spiral. The difficulty was that the city had to increase property tax rates—the main local source of revenue—more and more to finance the pensions from its shrinking tax base. By increasing those rates, Detroit made itself even less attractive to business and accelerated the process of decline until it crashed into a wall.

I sincerely hope that that scenario—at least, not such an extreme case—is not relevant for Scotland, but it is one to have in the back of one's mind. It may highlight that there are some kinds of welfare spending in which incentives are more important—for example disability benefits and even unemployment insurance. However, in the case of pensions—another kind of spend—it is difficult to see what the Scottish Government could do to change the number of pensioners. You might want to treat the different kinds of welfare spending differently; in the case of pensions in particular you would want to adjust for the age structure when looking at welfare benefits.

Professor Heald: Barnett was essentially a simple system, and one of the things that I worry about is that, over time, it has already become more complicated through the split between resource DEL and capital DEL, and because of financial transactions, rules about end-year flexibility and rules about budget exchange. It is important to keep the system as simple as possible to maintain a degree of intelligibility on the basis of much better published information.

On the welfare side, what worries me is that the numbers can be very big and people who do not know enough about the costings and the numbers will promise to offset, through Scottish Government action, changes that are made by the UK Government. As soon as you start getting the idea that welfare devolution means more spend and that you are going to offset austerity that has been imposed at UK level, things become extremely dangerous. If people want the welfare system in Scotland to be more generous, that is fine, but I wish they would tell me which main programmes—health, education or whatever—will be cut to fund it or which taxes will be increased to pay for it.

Malcolm Chisholm: That was extremely helpful. David Phillips in particular nailed his colours to the mast. What are the risks? You have done the risks for the different income tax scenarios, but it is a bit worrying if we are not getting pensions, although some of the benefits might be more skewed to older people. Are there risks with a higher proportion of the population being elderly?

David Phillips: I agree with Monica Ebell. You have to think about the risks and rewards of each of the different benefits; as Monica said, with disability benefits the balance lies on the side of rewards, because of the links with health and social care policy and the potential to make a real difference by integrating the two.

However, of course there are risks. If, for example, the somewhat more rapid aging of the population in Scotland was to lead to disability benefit spending per capita growing more quickly than in the rest of the UK, using a per capita indexation would mean that Scotland would find itself worse off.

On the other hand, the big trend that we have seen over the past 15 years is that disability benefit spending per capita in Scotland has been falling very substantially compared to the rest of the UK. The trend that is driving that stems from the 1980s when the big growth in disability benefits was to do with deindustrialisation and huge numbers of older male workers being shifted onto disability benefits. It was mainly Scotland, Wales and northern England that were affected by that. As that effect has started to shift and more of the disability benefit burden has moved to mental health and other issues that affect people more evenly across the UK, relative spending has gone down in Scotland and Wales and has gone up in the south-east of England. If that trend were to continue—it looks like there is scope for that, given that it has been continuing over the last few years—you might see Scottish spending on disability benefits continuing to fall per person, which would mean that Scotland would still potentially gain under the new system.

There is potential for risk and reward in the devolution of welfare benefits. There is also the potential to design a different system that could better suit Scotland or Scottish Government policy aims.

Malcolm Chisholm: That was very helpful.

The Convener: Whatever the drivers might be in the economy, if the Scottish welfare bill were to increase in the future, as someone said there would need to be tough decisions taken either to reduce expenditure in other areas or to increase taxes. The issue of how much we could raise by taxation is something that I have been interested in. If we were to apply a 1p increase only to the higher rate of income tax, what would that give us?

David Phillips: I am not entirely sure about the numbers on that and you would do better to ask the Scottish Parliament information centre because it has a model that allows you to simulate the impact of different changes in tax rates. I can see a SPICe researcher sitting over there and they would be the best person to ask.

The Convener: We shall look for that information.

Linda Fabiani is interested in welfare. Do you want to ask about it now before we go on to Stewart Maxwell on detriment?

Linda Fabiani (East Kilbride) (SNP): You covered what I wanted to ask, convener.

The Convener: I am sorry.

Linda Fabiani: That is quite all right.

Stewart Maxwell (West Scotland) (SNP): I want to ask a couple of questions about the two no detriment principles—the one that is based on there being no detriment at devolution and the one that provides for no detriment from decisions that are made after the devolution of powers. How do you see that working in practice? How would the Scottish and UK Governments determine what will incur a payment under the second no detriment principle? What rules could be enforced that would result in a payment taking place from a change in policy post-devolution of the powers?

10:30

Professor Heald: The first no-detriment principle, which I covered earlier, is the idea that the act of devolution of tax should not affect Scotland's relative position, whatever the arguments about that position are. The second no-detriment principle is largely incoherent. I suspect that part of the historical background to it is the big argument in the early days of devolution about the Treasury refusing to let the Scottish Parliament have the savings from attendance allowance when the Scottish Executive introduced free personal care.

There are areas where one has to be careful. If we want the system to work on an asymmetrical basis with some welfare expenditure being devolved, it is going to cause difficulty if the Scottish income tax system departs from that of the rest of the UK because there is an interaction with the benefits system. The idea of payments flowing backwards and forwards across the border is implausible; I think that it will be extremely fractious. The need to model what the numbers should be will create lots of jobs for the big accountancy firms to produce rival estimates, and I do not think that that will be a productive thing.

One of the worries is about the border area. On air passenger duty, I sometimes hear arguments that sound like we want to put Newcastle airport out of business. If we want the system to work, we should avoid things that are clearly targeted and which create resentment on either side of the border. Any detailed passing forward of compensation payments would be a recipe for disaster.

It all depends on the degree of co-operation between the Governments in thinking about issues such as the interaction between the tax system and the benefits system. However, we do not have good data. For example, HM Revenue and Customs surveys are done for HMRC purposes. With regional tax devolution and some regional welfare devolution, it becomes much more important to have better data, which probably means bigger surveys at UK level.

David Phillips: I agree with much of that, although I am not sure that I would go quite as far as saying that transfers should not be made in any circumstances. Professor Heald is right to suggest that it would be extremely complicated to work out what transfers we might want to make in relation to a given policy change, and such a system would be prone to disagreement because of different assumptions being made about behavioural responses, labour supply effects and consumption effects.

The example that I often give is the 50p tax rate. If Scotland wants to increase the tax rate to 50p on top incomes again, there could be several different knock-on effects on revenues in the rest of the UK. One might be that people work less. That would mean less national insurance as well, which would bite the Treasury. Should the Scottish Government pay the Treasury for those losses of national insurance? Also, people might shift their income from labour income to dividends income, because the 45p rate would still apply to that. That would mean an increase in revenues to the Treasury. Should the Treasury pay some of that back to Scotland? What if people moved to England to avoid the tax? Should the Treasury pay back those revenues? We can imagine the complexity of trying to work out all the different effects, and the scope for argument.

As a general principle, we should avoid compensation payments. However, there may be circumstances in which we can work out some first-round effects of policies. Maybe we should consider such a payment where a policy change has a direct impact on a tax, a benefit or a spending item in the rest of the UK and we can work out its first-round effects. With attendance allowance and free personal care, there would have been potential to work out a first-round effect. Another example is the interaction between universal credit and income tax. Say the Scottish Government cuts income tax and people's net incomes increase. If we ignore any behavioural effects of that, we can work out what it means in terms of the UK Government paying less universal credit, and the savings could be transferred to Scotland.

That principle can sometimes be used if there are direct and first-round effects only. However, if it is a general principle that is used every time there is a knock-on effect, it is completely unworkable and there is scope for disagreement all over the place.

Dr Ebell: As I am wont to do, I will again look abroad. Many federations that are successful in the long term have some sort of equalisation mechanism, but I am not aware of any federation that has a no-detriment principle. I imagine that David Phillips is right that the first-round effects are possibly workable but that, if you try to take it further it will become a mess. There are probably good reasons why no-detriment principles have not been applied in other places.

Professor Heald: As a condition for making no-detriment payments we should consider whether the system is symmetrical and whether, if the Scottish Government does something that benefits the UK Government, the UK Government should have to pay and vice versa. An asymmetric system whereby the Scottish Government had to pay the UK Government but the UK Government did not have to pay the Scottish Government strikes me as something to be avoided.

The Convener: Stewart, do you want to ask anything else?

Stewart Maxwell: No, that is all.

Rob Gibson (Caithness, Sutherland and Ross) (SNP): I will look at the idea of information analysis and transparency. A good fiscal framework needs sound financial reporting and it has been proposed that the Fiscal Commission in Scotland will be the mechanism by which we do our forecasting, as the Office for Budget Responsibility does in London.

What needs to be done to improve fiscal reporting in Scotland so that the Parliament can monitor what is going on? Who should be the arbiter if the OBR and Scottish Fiscal Commission do not agree?

David Phillips: Scottish fiscal forecasts are not the only public information needed to ensure that there is transparency and the Government is held to account. A proper public document needs to be laid before both Parliaments setting out how the block grant is calculated each year and giving a full working of the Barnett formula—not just the resulting totals, but line by line how the block grant was worked out and how the block grant adjustment was made, and the assumptions underlying that. If that happened, people would understand that we are forecasting the revenue growth of this and that. Documents should subsequently be published showing the reconciliation with actual outturns for revenue in the rest of the UK. It is about more than getting a better forecast for Scotland; it is about getting better information about how the fiscal framework operates from year to year.

If there was a disagreement between the OBR and the Scottish Fiscal Commission, I would point to what happens overseas. In Australia there is something called the Commonwealth Grants Commission that makes recommendations on how grants should be set, based on evidence from the states and the federal Government. The Commonwealth Grants Commission makes a recommendation and the federal Government usually acts on that recommendation. Ultimately, the federal Government makes the decision. There is the question whether such an approach—in which there are two reports that differ somewhat and the federal, UK or central Government makes a decision—would be seen as acceptable in the UK, or whether there would be some form of political negotiation.

When stamp duty was devolved, we saw that there were big differences in the OBR-verified forecasts and the Fiscal Commission forecast on revenues from Scotland. In the end, there was a negotiation between the two finance ministers and they split the difference in the middle. That is not ideal, but they are political issues and, although the technocrat in me would like to see an external arbiter that can impose a judgment, I do not think that that is feasible. Ultimately, I think that it will come down to politics and that the politicians will make the decision.

Professor Heald: It has to be a political negotiation, but it needs to be done on the basis of institutions that have the expertise, and the information has to be made transparent so that other people can see what has happened.

Dr Ebell: One potential mechanism for reducing conflict is to introduce some sort of ex-post compensation to the party that turns out to have been correct or misjudged. Say that the OBR and the Scottish Fiscal Commission disagreed on their forecasts and that had an impact on a spending allocation or block grant, and say that we used the OBR forecast and it turned out to be wrong, to the detriment of Scotland. In that case, we could think about some sort of ex-post compensation, and that could be written into a rule. Of course, it could go the other way. The flip-side would be that, if the OBR was wrong and that turned out to benefit Scotland, Scotland might have to accept an ex-post adjustment.

Just the threat of such an ex-post adjustment could have a positive incentive effect, as it would reduce the incentive for either side to game its forecasts. If people know that ultimately what matters is the outcome, they will try to give their best forecast. Any disagreement will really be about the kind of thing that reasonable people can disagree about.

David Phillips: I think that that is correct. The plan is that there will be reconciliations in subsequent years. As I understand it, an initial adjustment will be made to the block grant just before the fiscal year starts. The adjustment will be forecasted in year T minus 1 for year T and, when the outturn data comes in year T plus 1, there will be a readjustment through some kind of offsetting mechanism. So the method that Monique Ebell mentioned is in the plan. As she says, given that ultimately what matters is the outturn rather than the forecasts, that will mean that both sides have an incentive to give their best forecast. They will know that, at some point in the future, it will be the outcome that matters rather than the forecast.

Professor Heald: I am in favour of independent fiscal institutions, but one has to be careful. Such institutions operate with the fact that we do not actually know what is going to happen in the economy and there can be very big uncertainties. At the autumn statement, the chancellor suddenly found an extra £27 billion. If there had not been an independent OBR, the Treasury would not have dared to claim that there was an extra £27 billion, because we would all have laughed at it. The independent fiscal institutions are part of the political game, and they face a situation of big uncertainty. I read in a newspaper that the OBR provided five successive numbers to the Treasury and, unsurprisingly, the Treasury chose the best one for its purposes.

Tavish Scott (Shetland Islands) (LD): Are you therefore arguing that all these so-called independent bodies are not independent at all and they are gaming every bit as badly as the Government does?

Professor Heald: No, I was not saying that at all. They are technocrats operating in the context of lots of uncertainty about what is going to happen in the world. Things can change as the world changes and as the most recent data change. However, politicians will game them. In the context of the autumn statement, the political judgment of the Treasury would not have been to go to Andrew Tyrie MP in the Treasury Committee and say that, after all the trouble about tax credits, it had suddenly found an extra £27 billion, because Andrew Tyrie would have laughed at it.

Tavish Scott: I totally buy that, but I am more interested in the principle of how we move forward. We are told that all forecasting is to be independent. Of course, at the moment we do not have that in the Scottish Fiscal Commission because the Government has yet to agree that some of the forecasting should be completely independent, although I hope that it will agree to that. However, if the gaming that you describe goes on, the game is all political all the time, is it not? I thought that the reason why we have independent forecasters is that they give an independent forecast and that is that. I do not understand the whole point about needing some mechanism—I cannot remember Dr Ebell’s exact phrase—to get it right afterwards. I cannot see how that could work in a practical sense.

10:45

Dr Ebell: What I am saying is that if you make sure that what ultimately matters is the outcome rather than the forecast, that gives the right incentives to your body, however independent it is—or even if it is not independent—to get it right, which is ultimately what you want. Independence is always a bit relative. We know that people who are members of independent commissions might have different political leanings, so we should make sure that it is outturns that matter.

Tavish Scott: We need to get it right from the start. If not just Government but Parliament, academics and people watching the process do not have confidence in the Fiscal Commission or, for that matter, the OBR from the start, then the game is impossible. There has to be complete confidence that those institutions are independently assessing the numbers given to them and are coming up with their best-value judgment of what those numbers should be. Is that not right?

Professor Heald: But economists have different views about how the world works. There is also the problem of when data becomes available. There is a sense in which rather than everybody criticising the Treasury for its forecasts, people now criticise the OBR for the forecasts. There is a considerable element of blame avoidance and blame shifting going on.

There is obviously a potential difficulty if there is a conflict between the Scottish Fiscal Commission and the OBR. New Zealand has attracted considerable criticism from the IMF, in the context of article 4 consultations, for not having an independent fiscal commission—as far as I know, New Zealand still does not have one. However, one of the points that the New Zealand Treasury has made to me is that it has a very good record in terms of fiscal forecasting and that in a small country context you have to be worried about the dispersal of expertise. I think that that is an issue for Scotland too. Unless you are willing to put very significant resources into expertise, you are not necessarily going to improve the position.

Dr Ebell: I want to underline the point that, even with the best of intentions, we independent economists do tend to disagree with each other. There are many issues about which reasonable economists can disagree.

Tavish Scott: That is a fair point.

David Phillips: I will give a simple numerical example to explain why the approach of outcomes versus forecasts gives the right incentives to the two fiscal commissions to try to give independent, honest forecasts. Let us say that income tax is devolved to Scotland and you ask the two fiscal commissions to estimate what the revenues should be and how much should be taken off the block grant. The Scottish Fiscal Commission says that the figure will be £10 billion and the UK OBR says that it will be £11 billion, so the Governments negotiate a compromise and settle on £10.5 billion. It later turns out, however, that £10.7 billion is raised from that income tax in the first year. The method that we have says that in that case £10.7 billion should be taken off the block grant.

What would be taken off initially would be the £10.5 billion fudge that the Governments came up with, then two years down the line when they work out what the real number is they say "Actually, we were a bit wrong there, so we're going to take a further £200 million off to match that £10.7 billion." Irrespective of whether the OBR said the figure would be £12 billion and the Fiscal Commission said it would be £9 billion, or any other number, the number in the end would still be that £10.7 billion.

Because the fiscal commissions know that the forecast ultimately does not matter and that what matters is the outturn, they have no incentive with regard to the forecasts. However, in practice, they have an incentive to get the forecasts as good as possible for their own credibility. That is why making the process outcome related helps give independence and credibility to the forecast—I think that that is the point.

Tavish Scott: Your argument is that those outcomes should be reported to Parliament on an annual basis as part of the budgetary process.

David Phillips: Yes, and then you make an adjustment to the block grant adjustment once those outcomes come in.

Tavish Scott: Okay.

The Convener: We are leaving Linda Fabiani with a final quick question on VAT, which we have not covered.

Linda Fabiani: It seems to me that everything that we have covered today sounds very complicated and packed full of risk for Scotland. Is the assignation of VAT less complicated and less of a risk, with regard to both the initial mechanism and on-going?

Professor Heald: One of the issues that arose at the time of the Smith commission was the wish for it to devolve as much as possible. Assignment of VAT got into that picture. There are significant risks related to VAT and many of the same indexation issues arise.

Angus Armstrong and Monique Ebell have a paper in the *National Institute Economic Review* in which they talk about the Scottish Parliament being one of the most powerful devolved parliaments in the world. The figure that they use is control of 65 per cent of spend and 45 per cent of revenue. I do not accept that description—[*Interruption*.]

Linda Fabiani: Neither do I.

Professor Heald: —because, frankly, I do not think it matters what proportion of revenue the Scottish Parliament notionally raises. The key question is whether you actually have any credible varying powers. One of the big differences between Scotland and the US states, Canadian provinces and Swiss cantons is that they have a credible tax-varying capacity.

Being very much a tartan tax supporter, I wrote an article in 1997 saying that I worried about the potential atrophy of the system. My big worry going forward is that—after all the debates, political controversy and legislative process—we may get ourselves in a position where the tax powers are not usable. What matters is the usability of the tax powers.

Clearly the UK Government has responsibility; I have made the point to the committee before that the Scottish Parliament has to notify HMRC by 30 November what the Scottish rate of income tax and tax bands will be. The chancellor has until March to potentially sabotage that arrangement. If the UK Government starts doing that, it will totally destabilise the system.

I think that it was unfortunate that the tartan tax atrophied, but we would all agree that the stakes are much higher now.

Dr Ebell: I would like to respond to that briefly, because I think that it was a somewhat misleading representation of my views and those of Angus.

The Convener: I will allow you to respond briefly, but I do not want us to get into a debate about—

Dr Ebell: I do not intend to. I want to stick to VAT and rate-setting powers. Of course the ability to set rates is crucially important for incentives and is an important measure of fiscal autonomy for a sub-national Government.

Again, looking abroad, there is a good reason that VAT revenues are not often shared. When a VAT-like tax is delegated to a sub-national unit, it is usually not a VAT but a sales tax. We know that, for example, the United States and Canada impose retail sales taxes. The distinction is that you do not need to follow the entire chain of value added and disentangle where value was added at each step along the process; all that matters is where the final point of sale is. That is a much easier thing to disentangle.

I am afraid that it is rather unlikely that the rest of the UK will agree to shift to a sales tax, which would make devolution easier. That kind of devolution would also involve real rate-setting powers. It would allow Scotland to set its own rate of sales tax, which might well be different from that in other parts of the UK.

Professor Heald: It would also be inconsistent with the UK's membership of the European Union.

Dr Ebell: Yes, although that is up for grabs too, isn't it? [*Laughter*.]

David Phillips: I echo a lot of what Monique said. When it comes to the way in which those powers are actually devolved, calculating the adjustments and working out Scotland's share of VAT is incredibly complicated.

The calculations for the "Government Expenditure and Revenue Scotland" and HMRC estimates are not based on any real VAT data; they are based on estimates from household surveys, national accounts, gross value added and public sector accounts. They are not actual measures of the tax revenues but are pure estimates. Also, those estimates jump up and down quite a bit because of the sampling error in the surveys. I do not think that that will be appropriate for VAT.

The only way that I can see it working is, one, an impossible move to a sales tax, or two, a difficult move to separate accounting, which is being discussed in the context of corporation tax in Northern Ireland. That might also be required for VAT in Scotland, where you ask companies to account for transactions across the Scottish-English border, which becomes quite complicated and starts to undermine the single market of the UK. That approach is very complicated.

On whether there is any benefit from the VAT assignment, I am not quite as negative. I think that even if there is no power to vary the rate, having the assignation of something can still provide some incentives. The UK Government has a policy in England on assigning business rates revenues to the councils, at least partially, so that they have incentives to grow those revenues. The Scottish Government has the business rates incentivisation scheme, in which it cannot change business rates but councils get to keep a proportion of the growth in business rates. The idea is that that gives them more incentives. Therefore I think that there is some incentive even in assignation, but clearly there is a lot of complexity for less incentive and less autonomy than you get with full devolution and full rate-varying powers.

The Convener: I am afraid that we have to conclude the witness session. I thank all the witnesses for a very helpful session across a range of areas. If we do have a fiscal agreement at some stage, I would welcome your putting any views that you have on it to the committee in writing.

Intergovernmental Relations (Parliamentary Scrutiny)

10:56

The Convener: Item 2 is correspondence from the Scottish Government on intergovernmental relations.

Stephen Imrie (Clerk): I will speak briefly just to inform members. The committee will recall that in its recent report on intergovernmental relations, recommendation 3 was that a new written agreement on parliamentary oversight of intergovernmental relations should be drawn up between the Scottish Government and the Scottish Parliament.

Mr Swinney wrote to the committee on 15 December indicating his support in principle for a written agreement and offering his officials for initial discussions with parliamentary officials on such an agreement.

With the committee's approval, I will be happy to take forward those initial discussions with Scottish Government officials to produce, perhaps, some drafts and to bring them back for the committee to look at formally. I am happy to have a conversation with any member prior to doing so to make sure that I fully understand the key things that members want to see in the written agreement before drafts are produced.

The Convener: If no one wants to give a view, are we content with that approach?

Members *indicated agreement.*

The Convener: I want to make sure that we all know that next week we will be taking further evidence on the fiscal framework, specifically on the aspects that concern welfare. We will also have an update on the Scotland Bill from other committees.

We now move into private session.

10:58

Meeting continued in private until 11:14.

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