The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

FINANCE COMMITTEE

Thursday 3 March 2016

Session 4

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FINANCE COMMITTEE

9th Meeting 2016, Session 4

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*John Mason (Glasgow Shettleston) (SNP)

COMMITTEE MEMBERS

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

*attended

COMMITTEE SUBSTITUTES

Dr Richard Simpson (Mid Scotland and Fife) (Lab)

THE FOLLOWING ALSO PARTICIPATED:

Rt Hon Greg Hands MP (Chief Secretary to the Treasury)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Finance Committee

Thursday 3 March 2016

[The Convener opened the meeting at 09:23]

Decision on Taking Business in Private

The Convener (Kenneth Gibson): Good morning and welcome to the Finance Committee's ninth meeting in 2016. I remind everyone present to turn off mobile phones and other electronic devices, please.

Do members agree to take item 3 in private?

Members *indicated agreement.*

Fiscal Framework

09:23

The Convener: Item 2 is evidence from the Chief Secretary to the Treasury on the agreement between the Scottish and United Kingdom Governments on Scotland's fiscal framework. I welcome Mr Hands and invite him to make a brief opening statement.

Rt Hon Greg Hands MP (Chief Secretary to the Treasury): Thank you, Mr Gibson. I apologise for being late this morning because of traffic. I will try to rattle through my statement as fast as possible.

I thank the committee for inviting me to give evidence on the Scottish Government's new fiscal framework. In November 2014, the cross-party Smith agreement was published. In it, the commission stated that a new fiscal framework for the Scottish Government was needed. I am pleased to say that both Governments agreed and announced the fiscal framework on Tuesday 23 February. The details of the agreement were published on Thursday 25 February.

The historic deal will pave the way for the Scottish Parliament to become one of the most powerful and accountable of its kind in the world. Lord Smith of Kelvin said last week that the agreement

> "between the Scottish and UK governments sees the recommendations of the Smith Commission delivered in full."

I agree whole-heartedly with him. The deal that both Governments have agreed is fair for Scotland and fair for the rest of the UK.

Before we move on to the committee's questions, I will take a little time to set out some of the detail of the key elements of the deal that we have agreed.

Integral to the whole framework is how we determine the Scottish Government's block grant once it becomes more than 50 per cent funded by Scottish taxes. First, we have delivered on our commitment that the Barnett formula will continue to determine changes in the Scottish Government's block grant when the UK Government changes spending on public services. We have further agreed with the Scottish Government that the Barnett formula will be extended to cover devolved areas of welfare.

For tax, we have agreed to use the comparable model. Under that model, the Scottish Government holds the same risks and opportunities for devolved and assigned taxes as it does for devolved spending under the Barnett formula. That means that the Scottish Government holds the risk that tax per head will grow differently in Scotland from in the rest of the UK, and responsibility in relation to population change will be shared in the same way for tax as it is for spending under the Barnett formula.

However, for a transitional period over the next session of the Scottish Parliament, the UK Government will manage overall population change. That said, I should it make clear that the Scottish Government's funding during the transition period will still depend on the policy choices that it makes, on the relative performance of the Scottish economy and on Scotland-specific demographic changes.

To inform post-transition funding arrangements, we have agreed that an independent report will be presented to both Governments by the end of 2021. The subsequent joint review of the framework will ensure that we are still delivering the Smith recommendations, with the Scottish Government managing the opportunities and risks that are associated with its powers.

Although one element of the fiscal framework—the block grant adjustment—has garnered the most attention, there are other important aspects of the framework beyond that. We have agreed extensive new borrowing powers for the Scottish Government. The Scotland Bill was amended by the UK Government on Monday to reflect an increased aggregate capital borrowing limit, which will rise from £2.2 billion to £3 billion, and the Scottish Government's annual limit is being increased to £450 million, which will allow for increased investment in vital infrastructure.

For resource borrowing, we have agreed to extend the Scottish Government's powers, to reflect the new risks and opportunities that it will hold. The Scottish Government will be able to borrow up to £600 million each year for current expenditure, within an overall debt limit of £1.75 billion. In addition to being used to manage forecast error, that borrowing can be accessed if there is a Scotland-specific economic shock.

The Smith agreement was clear that both Governments should share the administration and implementation costs of devolution. The broad approach is that the UK Government will provide an agreed contribution to the Scottish Government, and the Scottish Government will then meet all implementation and on-going administration costs. The UK Government will provide £200 million to the Scottish Government to support the implementation of new powers. That funding will be a non-baseline, one-off transfer, which will supplement the block grant. In addition, the Governments have agreed a baseline transfer of £66 million towards on-going administration costs that are associated with the new powers.

With the exception of VAT assignment, where the costs will be shared, the Scottish Government will meet all costs of devolution. That will include costs borne by the UK Government—for example, in relation to the Scottish Government's income tax powers and powers to vary elements of universal credit.

Both Governments have agreed on how to treat the principle of no detriment due to post-devolution policy decisions. We have agreed that all direct effects—that is, financial effects that will directly and mechanically exist as a result of a policy change—will be taken into account. Behavioural effects—that is, those that result from people changing behaviour following a policy change—will be taken into account only in certain circumstances.

Finally, I will touch on the important issue of independent forecasting. We have agreed with the Scottish Government that the Scottish Fiscal Commission will be responsible for producing all forecasts of Scottish Government tax revenues and demand-driven welfare, as well as forecasts of Scottish onshore gross domestic product. I know that the committee has supported that, and I am pleased that it has been achieved.

The fact that we have now agreed a framework means that, subject to outstanding actions in both our Parliaments, we can get on with implementing the powers and the Scottish Government can get on with using them. I believe that the deal is indeed historic. It delivers the new powers over tax, welfare and spending that were agreed by the cross-party Smith commission, and I, for one, look forward to seeing how the new powers will be used.

09:30

The Convener: Thank you for that opening statement. I will now ask brief opening questions, after which I will allow colleagues around the table to come in. Because of time constraints, we have only 55 minutes or so. As a result, we will all try to keep our questions brief, and I will try to give everyone about eight minutes each.

First, I will touch on your comment about no detriment from policy spillover effects—the fact that

"there should be no detriment as a result of UK government or Scottish Government policy decisions post-devolution."

I asked John Swinney a question about that yesterday. I note that you referred to behavioural effects in certain circumstances, but will you give us an example of such an effect?

Greg Hands: It might be better if I gave an overview of the sort of spillovers that we are looking at. Essentially, there are three types of spillover that could be considered. First, there are direct spillovers, in which a change in welfare or tax policy in, say, a devolved area leads directly to a change in a welfare or tax policy in a reserved area. That is an example of a direct spillover that will be predictable and foreseeable, and we have agreed to pay heed to such spillovers. The third type is second-round spillover effects, which we have decided not to allow in the mechanism.

The middle area, if you like, involves behavioural impacts. I envisage that they will be fairly exceptional cases, but such effects are defined as being material, somewhat exceptional and perhaps unforeseen, and we desire to put in place an appropriate mechanism for dealing with them.

The Convener: You mentioned direct and behavioural effects. What was the third type that you mentioned?

Greg Hands: Second-round effects. One might argue that a tax or policy change could have a very second-round effect on tax policy, reserved taxation or something of that nature.

The Convener: Will you give us an example of that?

Greg Hands: It is difficult to speculate, but a small change in the administration of welfare, in the payment of welfare or in the level of a welfare payment might lead to an impact on a reserved tax such as national insurance.

The Convener: You mentioned capital borrowing in your opening statement. Paragraph 54 of the agreement says:

> "due consideration was given to the merits of a prudential borrowing regime in line with the Smith Commission's recommendation."

I will ask you the same question as I asked John Swinney yesterday: why was prudential borrowing rejected? After all, local authorities in Scotland are able to borrow prudentially, so why was there no agreement on the Scottish Government's being allowed to do the same?

Greg Hands: The issue was considered. Lord Smith asked us to consider it, but he did not say that we necessarily had to introduce such a system. We considered it, and both Governments agreed not to go down that road.

As you know, we agreed a larger capital borrowing limit, which I think is appropriate. We have increased the capital borrowing limit from £2.2 billion under the Scotland Act 2012 to £3 billion today. Perhaps more important is the percentage that can be borrowed in one year—in other words, the annual limit—which will now be 15 per cent, or £450 million. Both Governments reached that agreement, and I think that both Governments are satisfied with it.

The Convener: I realise that that is the agreement, but what was the reason for rejecting prudential borrowing?

Greg Hands: As I said, both Governments considered the idea. Both Governments were happy to go through with an increase in the existing capital borrowing limit, and I think that they both feel that that is appropriate and will work best.

The Convener: To stay with capital borrowing, I note that paragraph 59 of the agreement says:

> "The Scottish Government may borrow through the UK Government from the National Loans Fund, by way of a commercial loan (directly from a bank or other lender), or through the issue of bonds."

Will there be a preferential interest rate for that? Will it be a straight commercial loan, or will there be a premium to be paid on the interest rate?

Greg Hands: The national loans fund is already established, and it is the vehicle by which the Scottish Government can borrow from the UK Government at present. I am not aware of any proposals to change the national loans fund's mechanism as a result of the fiscal framework.

The Convener: One of the big issues in recent weeks—the media have speculated that this is one of the reasons why it has been difficult to reach agreement—was a report that said that the original proposals would have cost the Scottish budget some £7 billion over the next 10 years. I have not yet seen any UK Government response to challenge those figures. Was there any aim on the Treasury side of the negotiations to end the Barnett formula or to introduce a long-term reduction to Scotland's budget, which is clearly the perception that many people have here?

Greg Hands: No. Thank you for the question, which gives me the opportunity to put it on the record that that was never the UK Government's intention. The absolutely clear position of the UK Government as first set out in the vow, which the Prime Minister signed up to, was to keep the Barnett formula; it was a key part of the cross-party Smith agreement and it was set out in the Conservative Party's UK-wide general election manifesto last year. Our commitment to Barnett is absolutely clear. To be fair, I think that the only people who want to get rid of Barnett are those who are in favour of full fiscal autonomy or independence.

The Convener: So why was there a reluctance to adopt the per capita indexed deduction method?

Greg Hands: As I am sure you know, there were discussions about quite a number of models and their merits, and you will also be aware of quite a lot of external academic debate about the merits of the models. It is no secret that the UK Government's preferred model, which we felt best matched Smith, was the levels model, while the Scottish Government's preferred model was the per capita indexed deduction model.

At the end of the day, these are all matters for negotiation, and both Governments had to make compromises in different areas of the agreement. We now have a fiscal framework that both Governments feel is the right way to go forward, is the right thing to justify to our respective Parliaments and is fair for taxpayers in Scotland and in the rest of the UK.

The Convener: Thank you for responding to my questions. I open things out to colleagues around the table.

Lesley Brennan (North East Scotland) (Lab): Welcome to the committee, chief secretary. I want to ask about paragraph 66 and Scotland-specific economic shocks. In your opening statement, you referred to extensive borrowing powers and resource borrowing up to the new level of £600 million a year. Paragraph 66 sets out the criteria for drawdown in order to deal with Scotland-specific economic shocks, and I want to ask about the detail of that. The paragraph says:

"A Scotland-specific economic shock is triggered when onshore Scottish GDP is below 1% in absolute terms on a rolling 4 quarter basis, and 1 percentage point below UK GDP growth over the same period."

I want to be specific here, as it could be quite a critical point for Scotland. Yesterday, I asked the Deputy First Minister about his understanding of the term "absolute" in that sentence. I want to know whether that is absolute in real or nominal terms. The difference is quite significant. Can you clarify for us your understanding of the term and whether it is in nominal or real terms?

Greg Hands: Thank you for that question. First, I will explain the background because it is very important and leads to why we have to have independent fiscal scrutiny to derive the figures properly. The answer is that the Smith commission was clear that the Scottish fiscal framework must be consistent with the UK fiscal framework. The UK fiscal framework also uses four quarters of GDP—the rolling GDP that can both look at the outturn of GDP and take a forward look.

Looking backwards, we do not think that the Scottish economic performance has been—in those terms—particularly divergent from that of the UK as a whole since GDP figures have been properly collected. It was only in the mid-1980s that a Scotland-specific economic event might have been triggered, notwithstanding that one could be triggered in the future.

The two criteria are designed to show, first, whether there is a UK-wide economic shock, which it is the responsibility of the UK Government to meet, and, secondly, within that, whether there is a Scotland-specific shock. That is why we have to look at the Scottish GDP relative to the UK GDP.

I offer to write to the committee on whether it is nominal or real, because the answer is that it is whatever is in the UK fiscal framework, and the two frameworks must be aligned.

Lesley Brennan: I would appreciate getting that detail.

It is commonly accepted that a recession is a period of general economic decline, which is typically defined as being a decline in GDP growth in two or more consecutive quarters.

I forgot to say that there seems to be a word missing in the first sentence of paragraph 66: where it says "Scottish GDP", it should say "Scottish GDP growth".

We define a recession as a decline in two quarters, but when I asked the Deputy First Minister yesterday about the criteria that are set out in paragraph 66, he agreed that it could take up to 15 or 18 months to trigger the additional drawdown. Do you think that it is fair that the technical definition of a recession is two periods of negative growth, but under the criteria that have been set out, it could take 15 to 18 months for the additional borrowing to kick in?

Greg Hands: Let me try to answer that question. To reiterate, this needs to be consistent with the UK fiscal framework. In the UK fiscal framework we define an economic shock as being four consecutive quarters below 1 per cent growth—and that can be both outturn and forecast. It needs to be consistent with that. Ms Brennan is right to say that economists would normally define a recession as being two consecutive quarters of negative growth. However, what we are talking about is a divergence of enough consequence by Scotland, compared to rest of the UK, and our starting point is not negative GDP, but UK GDP of less than positive 1 per cent over four quarters.

The rule is intended to get at the relative performance of the Scottish economy. The absolute performance in terms of an absolute recession or a below 1 per cent event over four quarters would be dealt with by the UK Government. The question in front of us is how we define a Scotland-specific event.

Resource borrowing is not only about a Scotland-specific economic shock. That £600 million per annum limit can be for in-year cash management—for which there is an overall maximum of £500 million—and there is also £300 million for forecast error, as well as the £600 million for cyclical downturn. The cyclical downturn power will probably be the least used of the three powers within resource borrowing, although I do not downgrade its importance.

However, there are significant new powers, which is exactly what Smith said should happen. Smith said that there should be significant additional resource borrowing powers, and that is what we have delivered, particularly in the in-year cash management and forecast error powers.

09:45

Lesley Brennan: Okay—

The Convener: Hold on. I am going to have to let other members in, I am afraid, because we have less than 40 minutes left.

Jackie Baillie (Dumbarton) (Lab): I welcome the Chief Secretary to the Treasury.

The block grant adjustment mechanism has been agreed for a period of five years. You described that as a "transitional period". I wonder whether that is not just a sign that the Treasury has not quite given up on the comparable model. You are going to produce figures for the comparable model, which is your preference, and for the per capita indexed deduction model. Do you see any difficulty in publishing both sets of numbers, so that we understand the difference?

Greg Hands: No, I do not. There will be the comparable model, and then it needs to be reconciled with what the per capita indexed deduction model would have delivered. I do not see any problem with publishing those figures.

Jackie Baillie: Excellent—thank you.

There is a joint review in place for the mechanism beyond five years. I am curious to know what happens if, at the conclusion of that review, despite all the best efforts that might be put into it, the Governments do not agree on the way forward. What would be the status quo that we would default to? Would it be the pre-agreement position or the agreement that we have reached now?

Greg Hands: There is no status quo. The position is that there will be an independent review. There will be an independent report on the block grant adjustment during 2020-21 and there will be a review of the whole fiscal framework early in 2022. The most important thing is that the two Governments have it in their common interest to find a deal that is workable. We have done that before—we did it in relation to the Scotland Act 2012 and the Scottish rate of income tax, which is now coming in. I am glad to see the effect that that might have being debated in the Scottish Parliament. One of the intentions behind income tax devolution was to have political parties and democratic representatives debating tax rates in Scotland.

I am confident that we will find agreement again. For the current agreement, there has been a lengthy negotiation between the two Governments. I am not letting anybody into a secret there—we have had 10 meetings. However, ultimately, the two Governments have worked well together and we have an agreement that will work for both parties.

Jackie Baillie: Does that mean that you are going to be persuaded by the per capita indexed deduction model? The two models generate significantly different sums.

Greg Hands: It will depend on the course of Scottish economic development and economic development in the rest of the UK over the five or six years. The review has no preconceived outcome as to which model might be used, nor does it even state what the selection of models could be.

Jackie Baillie: I want to press you on that because, despite agreements being reached in the past, there is the possibility that agreement might not be reached. I simply want to explore what would happen in those circumstances. What would be the position of the Scottish Government relative to what the Treasury thinks? We need to look at all the possibilities in the round. If there is no agreement, what position remains? Would the transitional arrangement carry on, or would there be something else?

Greg Hands: There is no preconceived plan. It is clear that there is no default indexation model. The review will be entirely unprejudiced and will have no preconceived view. It will be an independent review set up by the agreement of the two Governments, and both Governments will have to agree its terms. As I said, it will be in the interests of both Governments to get an agreement and a deal.

By the way, I think that that will be a little easier in 2021 and 2022 than it is today, because by then we will have had five years of experience of the fiscal framework and we will have real evidence in front of us of how the framework has been working, which will help to inform the debate and in particular the independent review.

Jackie Baillie: I am short of time, so my next couple of questions will be brief. We expected to see detailed annexes to the agreement. Certainly, that was promised to us by the Deputy First Minister. When are those likely to be published?

Greg Hands: I cannot give a specific date, but they are being actively worked on and they will be available as soon as possible.

Jackie Baillie: I have one final question. We have dates for the implementation of most of the powers, but there is no date for the implementation of the welfare powers. I understand that switching off a benefit is probably easier than switching one on. However, are there any barriers to the transfer of those powers as far as the UK Government is concerned?

Greg Hands: No—I think that "barriers" would be the wrong word, but it is in the interests of both Governments, and in particular in the interests of the recipient of the benefit, that we ensure that the mechanisms are in place to allow that transfer to take place. It would not be in the interests of the UK Government or the Scottish Government for the transfer to take place prematurely, before the Scottish Government is ready to administer the benefit.

Ultimately, it will be down to the joint work between the two Governments to make sure that the time is right. I think that the Governments will work well in that space, and nobody would want to do anything that could jeopardise in any way the welfare recipient's ability to get that benefit.

Mark McDonald (Aberdeen Donside) (SNP): To assist us in our parliamentary scrutiny, would you be willing to publish the documents that the Treasury put forward with its proposals as part of the negotiations and discussions that took place? That would be very helpful in enabling us to gain a greater understanding of what happened during the negotiations, and of the starting points and changing positions of each Government.

Greg Hands: First, I point out that we have published some quite extensive documentation. That includes the communiqués after each of the 10 joint exchequer committee meetings, which give the items discussed and an idea of progress; the fiscal framework itself; and the technical annex, which is to follow. That is a significant amount of documentation.

With regard to the documentation relating to the negotiations, both Governments agreed not to provide a running commentary during those negotiations. To the best of my knowledge, working papers relating to the course of negotiations of that nature between the Governments have not in the past been published, and I personally think that it would be an unwelcome development.

There will be a number of further negotiations and agreements between the two Governments—and between the UK Government and the other devolved Administrations—in the coming years. Intergovernmental negotiations need a space in which the Governments can be informed and put forward papers in the knowledge that that information will remain confidential to and preserve the integrity of those discussions.

Mark McDonald: Sure, but you will appreciate that there is speculation. The convener asked you earlier about the speculation—which I am led to believe is well founded—that the Treasury's initial starting point was a model that would have led to a reduction over time in Scotland's finances. You have contested that that is not an accurate reflection of the UK Government's position. Do you not think that it would assist the situation if we were able to see the detail of what the UK Government had put on the table?

Greg Hands: I am clear that everything that we, as the UK Government, have done and proposed at all times throughout the whole negotiation process has been consistent with Smith.

I do not recognise the figures that you and the convener have used. I heard one of those figures for the first time at Prime Minister's question time yesterday. It was put as the very first question to the Prime Minister—right at the top of the list—that that figure was used.

I know that there has been a lot of academic debate, and a lot of the academic sources have tried to look forward. Ultimately, in taking any sort of look forward, the situation will depend on economic performance, even in the transitional period. You have to recognise the risks and responsibilities that the Scottish Government is taking on in this area. It is taking on economic risk; the risk that tax per head in Scotland grows differently from tax per head in the UK; and demographic risk. Apart from the headline population risk, there is demographic risk within that, in terms of the increase in certain population types, such as taxpayers, the elderly and so on, relative to the rest of the UK. That demographic risk will be held by the Scottish Government.

A lot will also depend on the policy choices of the Scottish Government and the UK Government. After all, the powers are designed so that the Scottish Government can make policy choices. It is often difficult to look forward with numbers.

Looking backwards over the past 15 years, compared to Barnett as the status quo, the model that the UK Government recently proposed would have yielded an additional £6.5 billion in funding to the Scottish Government. That was the most recent form of the comparable model that was proposed by the UK Government.

Mark McDonald: Returning briefly to Jackie Baillie's question about what happens in 2022 if there is no agreement, I appreciate that you want to view the matter through an optimistic prism, which is fine, but the committee also has to consider the what-ifs.

Yesterday, the Deputy First Minister indicated that, if there was no agreement, we would default to the status quo of the time, which would be the continuation of the transitional model. You appear to have indicated that that is not the case. If there is no agreement, there has to be something to default to. What is your understanding of that? Even if the two Governments do not reach agreement, there still needs to be some form of fiscal framework beyond 2022, so what happens in that circumstance?

Greg Hands: Let me give again the answer that I gave earlier: there is no default. Both Governments will need to agree the arrangements beyond the transitional period. I think that we will be able to do that because we have done it before, and we will have had real-life experience of the fiscal framework and the devolution powers, which by that point will have been in place for five or six years.

Mark McDonald: I understand that you believe that an agreement will be reached. The point is that if no agreement had been reached on the fiscal framework by now, the Scottish Government would have been recommending that we reject the legislative consent motion. What if there is no agreement in six years' time? Over that period, those powers will have been here and will have been exercised, and the transition for the fiscal framework will have been running. We cannot say that we will accept devolution without a fiscal framework; if we cannot reach an agreement, some fiscal framework will have to continue. We cannot get to 2022 and, at the last gasp, just say, "We have not come to an agreement." Something has to follow on. What is the UK Government's understanding of what would happen in that circumstance? However remote you think the possibility might be, you still have to have a position on what will happen next.

Greg Hands: There would be no default options. The point of the independent review is to look at that question and at the operation of the agreement. It would be difficult for either Government to go against the review's central substance; after all, its importance is the reason why we have agreed to have one in the first place.

I remain confident that the Governments will find a way through this. Although it is difficult to know exactly who will be in Government in that year, the onus will nevertheless be on both Governments to find a way through. That is why we will have the independent review. I have confidence in the process.

The Convener: I should say that the PMQ that you referred to was asked by my wife, Patricia Gibson MP.

Greg Hands: Ah, right. It is a good thing that I was complimentary about it, then.

The Convener: Almost.

Gavin Brown (Lothian) (Con): Yesterday, when Mr Swinney was asked about the joint exchequer committee and what it looked like, he said that it was basically him and you, flanked by officials. Such a system clearly works if the two personalities can work well together, as appears to be the case at the moment, but there could well come a time—say, five or 10 years down the line—when the two individuals do not work quite so well together. What structural changes to the joint exchequer committee are needed to make sure that the process can flow, regardless of who is in post?

10:00

Greg Hands: That is a reasonable question. I do not envisage any structural changes to the JEC at the moment. Technically—if I am not mistaken—it comprises the Deputy First Minister, me, the Financial Secretary to the Treasury and other people at the request of the two Governments. It has been in place for some time now, and it has worked pretty well. I see no issues there, nor have I any plans to change it, but I am sure that, if such a need was felt, the two Governments would discuss it and come to an amicable agreement.

Gavin Brown: With regard to the Scottish reserve, which we discussed yesterday, the increase in size and flexibility is a positive development. How were the figures and the conditions of the Scottish reserve arrived at by the two Governments?

Greg Hands: The Scottish reserve, or the cash reserve, is an underappreciated part of the agreement. It gives the Scottish Government significant budget flexibility. It is important to understand that it is different from resource borrowing, in that it is not borrowing but a reserve—others might call it a rainy-day fund—that will assist with longer-term planning and give the Scottish Government greater flexibility in its budget. The limit for the reserve is a sizeable £750 million, and it is flexible and powerful, with annual drawdown limits of £250 million for resource and £100 million for capital.

The reserve is a powerful mechanism to assist with budget management, and I think that both Governments really appreciate it. Particularly with the greater risks and responsibilities that are being taken on, the Scottish Government needs a greater ability to plan for the long term.

Gavin Brown: Thank you.

You were asked earlier by a couple of people about behavioural responses to various changes linked to the no-detriment principle, and you talked us through direct effects, which are reasonably straightforward, and secondary effects, which are off the table. For me, the most difficult effects are the ones in the middle, which are the behavioural effects.

When I was a corporate lawyer, we would, in signing up to an agreement, spend a long time working out all the things that might go wrong and lead to disputes. In effect, we would work out at a time when the two parties were friends how those disputes might be resolved so that, when it came to it, there was a simple contract to look at.

The agreement has an outline of how disputes might be resolved. Some disputes are unforeseen and we cannot do much about them, but some can be foreseen. Is there merit in both Governments, at a time when relations are clearly very good and there is no dispute, deciding on some of the issues that could arise over five or 10 years and working out how we might approach them, so that there are some illustrative examples? Are you willing to consider that?

Greg Hands: That is a reasonable question. We were trying to get a system in which direct spillover effects would definitely be dealt with; of course, those could go either way. We wanted a mechanism in place for the behavioural impacts that would be used not regularly but exceptionally. We do not want to have an annual reconciliation. There might be a little bit of this and a little bit of the other across the border, but I do not think that such an approach would be in the long-term interests of either Government, or of financial and budgetary stability.

We wanted to put in place a mechanism in which behavioural impact could be assessed and informed by independent evidence, perhaps from the Office for Budget Responsibility and the Scottish Fiscal Commission, and the decision would ultimately be for the two Governments, following a dispute resolution process that was explicit in the fiscal framework. We wanted such a mechanism to be included, but I do not think that either party would want it to be used regularly. We want people to be able to operate and be flexible on things such as tax rates, with the Governments making decisions that they believe, given the environment, are appropriate for their respective taxpayers.

Gavin Brown: You talked about independent forecasting, which both Governments have signed up to. Will you explain the reasoning behind getting the forecasts done independently by the Scottish Fiscal Commission?

Greg Hands: That is incredibly important, and I pay tribute to your committee, Mr Gibson, for the good work that has been done on pushing for it.

From the UK Government's perspective, when we went down that road in 2010 with the creation of the Office for Budget Responsibility, we were seeking to move to a point at which the forecast could be well trusted as being independent from Government and independently derived. It is not really for me as a member of the UK Government to dictate in any way what the Scottish circumstances would be, but given that the fiscal framework makes comparisons between UK and Scottish GDP, I think that it is essential for the two forecasts to be done in the same way—in this case, independently of Government—so that we are able to make that assessment.

Gavin Brown: That is helpful.

John Mason (Glasgow Shettleston) (SNP): Good morning, Mr Hands.

Greg Hands: Good morning, Mr Mason. It is good to see that you have prospered since I last saw you.

John Mason: Yes, I have moved up in the world.

The baseline adjustment to the block grant is touched on in paragraph 11 of the heads of agreement, which says:

> "The initial baseline deduction for tax will be equal to the UK government's receipts generated from Scotland in the year immediately prior to the devolution of powers."

When the issue was discussed previously, the suggestion was that, at least for some taxes—obviously, they go up and down from year to year—a five-year average or something like that might be more appropriate. Can you explain why it was eventually agreed simply to focus on the single year before devolution?

Greg Hands: I think that that is consistent with how devolution has always been done. The approach has always been to look at year zero—in other words, the year in which devolution happens. That is an important principle, because the UK Government might well have taken different policy decisions in previous years that could have distorted the picture. We want to look at the impact at the point of devolution.

There is one exception, which is not very substantial with regard to the amount of money involved. I am referring to cold weather payments, which, in effect, reference the weather. Whether that is influenced by Government policy decisions is a matter of separate debate; I think perhaps it is, but I am straying into another area of Government policy. What we have agreed is that, with cold weather payments, we will take an average over a longer period. In general, however, one wants to stick to the principle of looking at the impact at the point of devolution.

John Mason: So even with property tax—which was stamp duty land tax and is now land and buildings transaction tax—if the year before devolution was particularly poor, we would still gain, because growth would be expected. Nevertheless, you are happy to live with that.

Greg Hands: It is important to be consistent on such matters and to deal with things at the point of devolution.

John Mason: There have already been some questions about the indexation mechanism. As paragraph 17 of the agreement says, the comparable model will be used and an adjustment made for what will be delivered by the indexed per capita method. Will that information be published? Will all those figures be put in the public domain?

Greg Hands: I am sorry. Are you asking whether the model—

John Mason: I am asking about both models. Will it be possible to see what the figure would be if just the comparable model were used and what adjustment is made as a result of the indexed per capita method?

Greg Hands: Can I think about that and get back to the committee on precisely what will be published in relation to the models? I think that it will be in the interests of everyone to have as much transparency as we can reasonably have.

John Mason: That is fine.

Admin and implementation costs have been touched on. You came up with the figure of £200 million. Did you do so just by splitting the difference? One of the no-detriment principles was that whoever made a decision on powers would carry the cost. Given that many of these decisions are made at Westminster, I have always wondered why the Scottish Government has to pay the cost of switching off a UK tax. That does not strike me as reflecting the no-detriment principle.

Greg Hands: The Smith report is very interesting in that area, because in saying that the UK Government should bear a share of the costs of devolution, it changes the precedent. You are right that both Governments estimated the implementation costs at around £400 million, and we agreed to split that down the middle and pay £200 million each.

If you were to say that that did not sound like much, I would say that—if I am correct—two years ago the Scottish Government assessed the costs of independence as a whole at only £200 million to £250 million. I think that £200 million is a generous number with regard to meeting implementation costs. I also point out that we are transferring £66 million, in terms of transferring the marginal savings from departments.

John Mason: I realise that a lot of work is still be done on VAT, but I think that it is has been agreed that the consumption method will be used. The principle will be that the end consumer will pay VAT. If we built a factory in Scotland, that would add value, and normally VAT would be received because of that, but Scotland will not receive any of that VAT. Is that principle fair?

Greg Hands: We agreed what we agreed, and the VAT assignment was not a major part of the debate. Both Governments were comfortable and happy with how we are going to do it. VAT assignment will be fully online a little later than income tax; it will come in in 2019-20, after proper assessment of the workings of the methodology over the time until then. Both Governments are in agreement on and happy with the methodology.

John Mason: I am the one member of the committee who disagrees with the proposition that the SFC should be doing forecasts. Would you accept that the OBR is not really independent? There have been stories about it being leant on, and it is dependent on HM Revenue and Customs for its figures. Independence is not linked to who does the forecasts, is it?

Greg Hands: I strongly disagree with that. The OBR is a robust and independent body. One must recognise the difference between independence and not interacting. That is where one must get it right. We must have interaction between, in our case, the OBR and the Treasury. The OBR needs to assess the potential policy changes that the Treasury produces. At the moment, in the lead-up to the budget, there will be interaction between the Treasury and the OBR to look at the scorecard. The Treasury needs to say what it is proposing and it needs to ask the OBR what it thinks the impact would be if it were to do this, that or the other. The OBR quite rightly comes back with an assessment, and there is an iterative process that can go on for some time. In no way does that call into question the OBR's independence. It will give an entirely independent view.

You may be talking about a case that recently came to light in which a Treasury minister had very indirectly passed on a suggestion. I looked at that email exchange, which was between the OBR and my predecessor chief secretary, and I did not think that there was anything wrong with it. He was not seeking to change the forecast in any way.

I am confident in the robustness and independence of the OBR. It has been given a strong external review by its Canadian equivalent and Robert Chote has been appointed for another term. It is a very good body and it has transformed the area of UK budgetary forecasting. Making forecasting independent has been immensely beneficial. I do not hear anybody in Westminster proposing to go back to the old system of the Government doing its own forecasts.

Jean Urquhart (Highlands and Islands) (Ind): Good morning, Mr Hands. Early in your opening remarks, you stated—I am paraphrasing—that, under the new powers, Scotland becomes one of the most powerful devolved Governments in the world. That is patently untrue. Research shows that many devolved Governments are more powerful. Will you stop using that phrase? It is very irritating when it is not fact.

Greg Hands: We can have a disagreement about that. I am about to appear before the Devolution (Further Powers) Committee, which may well have questions on this area. Even if we do not agree on that, we can say that through the Scotland Bill and the fiscal framework, the Scottish Parliament will become a lot more powerful and a lot more accountable. I hope that you and I can agree on that. Accountability is also incredibly important. Accountability to taxpayers will be increased, which is one of the intentions behind tax devolution.

10:15

Jean Urquhart: I do not doubt that the arrangements have merits, but they will not make Scotland the most devolved regional Government in the world. Anyway, I will not go on with that.

In talking about the tax base, you highlighted a number of risks to Scotland with regard to tax per head or population growth. It seems to many of us that we have a lot of the risks but often not enough of the responsibility to change that situation; after all, it is very difficult for Scotland to grow its population, given that bringing people into the country and so on is reserved. We therefore lack the power to grow many of the incomes that are at risk. Do you agree?

Greg Hands: No. I think that you are talking about immigration powers, which are reserved. It is quite right that those powers remain reserved; you and I might differ on that but, nevertheless, I think that that is right.

Secondly, the Scottish Government has considerable powers to attract to Scotland not only those coming to the UK in the first place and choosing where to go but those who already live in the UK. It already has significant powers over housing, transport, skills, schools and health; it has brilliant universities; and it has all kinds of different things to attract more population from the UK and those moving to the UK from abroad. I therefore do not agree that the Scottish Government does not have powers to do something about population.

Jean Urquhart: We will have to agree to differ on that.

There is a bit of a discrepancy between the vow and the Smith recommendations, and a lot of people—including, I think, in your Government—are concerned that the vow was a declaration made in desperation when it looked as though we might gain independence and that it, the Smith commission and the following legislation were done in haste. Does that issue need to be worked on almost immediately during the declared transition period? What will happen in Scotland over the next five years will be very significant and we need real clarity about the outcomes, including in respect of the Barnett formula and its calculations. However, that is going to take a long time, and the work on looking at the kind of data that is required should start not in the final year of the five-year period but now. Do you agree that there should be some review to allow this committee and this Parliament to look at things in detail at least annually or every six months between now and then?

Greg Hands: I am sure that, over the five-year period, there will be plenty of commentary on the workings of the fiscal framework, but if you are suggesting that we have an on-going five-year review that starts now, I have to say that that it is not something that I would particularly favour and it is not what is in the agreement. It has taken us 10 months to get to this agreement, and I am feeling no natural urge to start reviewing it right away after all that work. However, I am sure that there will be plenty of independent commentary, as—to be fair—there has been on the different models and the negotiations on the fiscal framework up to now to help inform the process.

Actually, the most important thing—and the reason why I have a lot of confidence in the review—is that it will look at five years of real experience prior to that in a way that we cannot really do at the moment. We can look back at what models would have done in the past, and we can think about and speculate on what models might bring in future, but by the end of the five years, there will be real experience that will inform the review.

The Convener: That concludes questions from committee members, but I have one further question. Will the OBR continue to forecast revenues for Scottish taxes, or will the Scottish Fiscal Commission be the only forecast that will be published?

Greg Hands: That is a good question, and I genuinely do not know the answer to it. If that were to be the case, I do not think that it should inhibit the Scottish Fiscal Commission in any way. However, I will write to the committee on the matter. Clearly, the OBR has to assess GDP, taxation revenues and so on throughout the UK, but I think that you are asking whether it would specifically provide a Scotland-only breakdown. I would have to check that, and I would also have to check exactly what the Office for National Statistics, too, is doing in that space. Instead of giving you my idle speculation, I will write to you on that point.

The Convener: That would be very much appreciated. I also appreciate your succinct and very clear answers to the committee, chief secretary, and I want to thank committee members in view of how tight for time we have been. We started more than 20 minutes late, and I point out that, if this were a Department for Work and Pensions interview, chief secretary, you would have been sanctioned for being more than 15 minutes late.

As you have a busy morning, we will not keep you any further. Do you wish to make any further points before we wind up the public session?

Greg Hands: The only thing that I would say is that the traffic in Edinburgh is perhaps not as bad as it is in my west London constituency, but it is still pretty bad at rush hour. I also point out that I took the first flight from anywhere in London to Edinburgh, and there was no way that I could have been here earlier.

The Convener: I know, and I understand that you probably could not have stayed overnight beforehand because of work at the House. In any case, I appreciate your coming—it was great to have you. We got through a lot this morning, and I wish you well in your appearance at the Devolution (Further Powers) Committee.

That being the end of our public deliberations, I move the meeting into private.

10:21

Meeting continued in private until 10:37.

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