**OFFICIAL REPORT**
AITHISG OIFIGEIL

# Finance and Constitution Committee

**Wednesday 30 November 2016**

Session 5

The Scottish Parliament
Pàrlamaid na h-Alba

# Wednesday 30 November 2016

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## FINANCE AND CONSTITUTION COMMITTEE
**14th Meeting 2016, Session 5**

**CONVENER**

*Bruce Crawford (Stirling) (SNP)

**DEPUTY CONVENER**

*Adam Tomkins (Glasgow) (Con)

**COMMITTEE MEMBERS**

*Neil Bibby (West Scotland) (Lab)
*Willie Coffey (Kilmarnock and Irvine Valley) (SNP)
*Ash Denham (Edinburgh Eastern) (SNP)
*Murdo Fraser (Mid Scotland and Fife) (Con)
*Patrick Harvie (Glasgow) (Green)
*James Kelly (Glasgow) (Lab)
*Dean Lockhart (Mid Scotland and Fife) (Con)
*Ivan McKee (Glasgow Provan) (SNP)
*Maree Todd (Highlands and Islands) (SNP)

*attended

**THE FOLLOWING ALSO PARTICIPATED:**

Alan Barr (Brodies)
Professor David Bell (Royal Society of Edinburgh)
Yvonne Evans (Law Society of Scotland)
Professor Graeme Roy (Fraser of Allander Institute)

**CLERK TO THE COMMITTEE**

James Johnston

**LOCATION**

The David Livingstone Room (CR6)

# Scottish Parliament

## Finance and Constitution Committee

*Wednesday 30 November 2016*

*[The Convener opened the meeting at 09:32]*

## Decision on Taking Business in Private

**The Convener (Bruce Crawford):** Good morning, colleagues, and welcome to the 14th meeting of the Finance and Constitution Committee. A happy St Andrew's day to you all.

The first item on our agenda this morning is a decision on whether to take items 4 and 5 in private. Are members agreed?

**Members** *indicated agreement.*

## United Kingdom Autumn Statement and Scotland's Budget

09:32

**The Convener:** Agenda item 2 is evidence from Professor Graeme Roy, director of the Fraser of Allander institute, on the United Kingdom autumn statement and Scotland's budget. Members have received copies of Professor Roy's slides from the briefing that he conducted last week. I am sorry that I could not be at your briefing, Professor Roy, but I know that some members were there. I warmly welcome you to this morning's meeting. You may wish to make an opening statement.

**Professor Graeme Roy (Fraser of Allander Institute):** Yes, please. Thank you for the invitation to come back to the committee and give our thoughts on the autumn statement and the potential implications for Scotland.

A number of things in last week's statement were quite interesting. First, there were the Office for Budget Responsibility's revisions to growth for the next couple of years. The OBR forecast that the economy would slow slightly next year, to about 1.4 per cent, going back up to 1.7 per cent the year after. In relative terms that is a significant slowing but, in comparison with other forecasts, it was slightly more on the optimistic side. Crucially, the OBR expects that, at the end of the years of the forecast period, growth will return to being close to trend.

Obviously, there is a lot of uncertainty about that. There is quite a lot of variation among the different forecasts for the next couple of years and that has implications for the public finances. The big thing is what will happen to the public finances, with a significant increase in borrowing over the next few years relative to what George Osborne predicted back in March.

I guess that the big number to take away is the increase in borrowing of £120 billion. There are a couple of interesting points with regard to that figure. About half of it is expected to come from the weakening of the economy from Brexit, and some will come from classification changes. However, in addition, a slightly poorer performance from tax receipts this year, even before the Brexit situation, has had an impact on the overall public finances. Tracing that through, the chancellor then faced a decision about what to do with public spending in the next few years. What we saw, particularly on the revenue side, was a decision to wait and see and continue largely with George Osborne's departmental resource spending plans. The Scottish budget is therefore expected to fall about 3 per cent in real terms, assuming that Scotland matches UK tax revenues over the next few years.

The big difference was on capital, because there was quite a significant stimulus to capital investment, which means £800 million coming to the Scottish budget cumulatively over the next few years. We can look at that either as the glass being half full or as it being half empty. On the one hand, it is quite a significant increase from where we are just now. If we add the new borrowing powers to the additional £800 million, that is a further real-terms increase in capital borrowing. The full amount of capital that the Scottish Government could have in 2020-21, relative to 2010-11, is slightly higher in real terms when we add the full amount of capital borrowing, which is interesting. On the other hand, it is still relatively low in comparison to 2010-11 purely on the capital departmental expenditure limits, so it is down in real terms.

As I said, we can look at the situation in two different ways. However, there are obviously implications for what happens with the Scottish budget, and we will see the details of that in the next couple of weeks.

**The Convener:** Murdo Fraser has a question.

**Murdo Fraser (Mid Scotland and Fife) (Con):** Good morning, Professor Roy. Before I come to my question, I want to pick up on your last point about the overall envelope of capital spending, which is quite interesting. What restrictions does the Scottish Government have on how it can borrow for capital projects?

**Professor Roy:** Under the new fiscal framework, Scotland can borrow from largely two sources if it wants to: the private market or the Public Works Loan Board, where it can get the same rate as the UK. The sum of £450 million additional capital borrowing at the end of the period is quite significant, given the additional money that is coming as well.

**Murdo Fraser:** Thank you. I want to ask about the overall size of the budget. Figures that we got from the Scottish Parliament information centre tell us that, in real terms, the budget for 2017-18 will be up £130 million on that for 2016-17. As far as I can work it out, that splits as £23 million up on resource DEL and £106 million up on capital DEL. Are those figures in line with your assessment?

**Professor Roy:** Yes. There are two numbers that are quite interesting, one of which is for what happens between this year and next year; the other is for what happens towards the end of the forecast period. The budget between 2016-17 and 2017-18 is pretty much flat, but there is a small real-terms increase in revenue terms. One of the reasons for that is how the deflators have changed on, for example, imputed rent. I will not go into a big discussion about imputed rent, but there was a change in the methodology for using it. The deflators have therefore changed and have become slightly lower, and some in-year adjustments to budgets have lowered the cash-terms figure for 2016-17 and increased that for 2017-18, relative to where it was. There is therefore a modest real-terms increase between 2016-17 and 2017-18, then additional cuts coming on the back of that. That is slightly different from what was planned earlier this year.

**Murdo Fraser:** I wonder into what context that puts all the discussions that we had prior to the autumn statement. You might remember when you came to the committee previously that we talked about the potential for cuts in the resource budget and the impact that that would have on the Scottish Government's planning. The expectation that there might be further reductions was, of course, the justification for the Cabinet Secretary for Finance and the Constitution delaying publication of his budget. However, such reductions have not happened, so Scotland could perhaps have seen its budget much earlier.

**Professor Roy:** The first thing is that the plans have remained largely unchanged from those of George Osborne. As I said, there has been the slight change in methodology for the deflator, which changes whether it is increasing or decreasing from one year to the next, but that involves relatively small numbers. However, in the run-up to the autumn statement, the big question was what would actually happen.

As we said in the September report, there was a lot of uncertainty about, and the scenarios that we had potentially had a stimulus this year—an actual, genuine, real-terms cash and real-terms increase from this year into next—or additional consolidation. I guess that the chancellor faced that difficult balancing act between further consolidation or a stimulus, and in the end he has almost decided to wait and see. To be fair to the Scottish Government in that context, things were going to turn out one way or the other; there was a lot of uncertainty, and I think that the Government's position was a justifiable one to take.

Where things get slightly more interesting is what happens in the future. This year, the budget potentially being flat in real terms almost hides, in a sense, some of the challenges that are coming down the line—some of the difficult choices that will come in years 2, 3 and 4. That moves into the issues about whether a one-year budget is appropriate or whether the Government needs to set out spending plans going towards the end of the parliamentary session.

**Murdo Fraser:** Thank you.

**The Convener:** It is interesting to see the front page of *The Scotsman* this morning and some of the projections that are being made—I do not know whether Professor Roy has had a chance to see it. I do not know whether your resource plans and the historical context slide in the material that you provided to the committee reflect exactly the same numbers, but they seem to reflect the same direction.

Can you talk us through the longer term? If any cabinet secretary is setting their budget for the next financial year, they will obviously need to consider the longer-term issues.

**Professor Roy:** In essence, we have the budget increasing very slightly in real terms this year into next—a £20 million real-terms increase, depending on which adjustment is made for inflation. However, our projections up to 2020-21 show around an £800 million real-terms decrease between 2016-17 and the end of that period. That works out at about a 3 per cent real-terms cut.

With regard to the number today that is slightly higher than that, we have to be careful to avoid double-counting. In essence, that figure adds in the implications of some of the commitments that the Scottish Government has made, such as for health and childcare, which means that other non-protected areas face a cut of closer to £1.2 billion to £1.3 billion. I guess that that is a discretionary choice by the Scottish Government. It is not the budget being cut by £800 million; it is a decision to prioritise some areas over others, which then means that those other areas have to take a larger real-terms cut.

In our presentation, depending upon which assumptions we use about growth, that works in anywhere between a 10 to 13 per cent real-terms cut in the unprotected areas. The crucial point is that that is part of a discretionary choice by the Scottish Government to make those commitments in those areas. You need to watch for slight double-counting there.

**The Convener:** Okay. That leads us neatly to James Kelly.

**James Kelly (Glasgow) (Lab):** You describe a situation in which the budget for next year will be almost flat—a small real-terms increase—and then there is cumulatively an £800 million decrease over a period of time. You also paint a picture in which the UK economy will be smaller, unemployment will rise, inflation will rise and wages will not rise at the same rate as inflation. How will those other factors that result in a smaller-sized UK economy—such as inflation, lower growth, rising unemployment, wages not rising as high as inflation—impact on the Scottish budget?

**Professor Roy:** I offer one point of clarification. The £800 million cut in real terms is not cumulative; it is just the difference between 2016-17 and 2020-21, so the cumulative figure will be bigger. That figure is the difference from one year to the next. There are the cuts in 2017-18 and 2018-19 as well, so the cumulative number will be bigger than £800 million.

**The Convener:** What do you project them to be?

**Professor Roy:** I could add them up for you.

Your wider point gets into the overall outlook for the UK economy. The Office for Budget Responsibility revised down its forecasts for the UK economy over the next couple of years, and what was really quite interesting with its forecasts—without going into too much detail—was what it assumes about productivity. Weak productivity growth is one of the key challenges that we have faced since the financial crisis, and it is projected to continue for at least the next couple of years. That will drive what happens to earnings, for example—we expect that earnings will grow much more slowly than had originally been predicted. With inflation projected to rise, that will lead to lower real incomes for households.

09:45

There is a balance between an economy that is slightly slower, which feeds through in real household incomes and higher inflation, and continued consolidation on the public finances side. There is a mix of pressure on households and continued consolidation on the Government side. That means that there will be less resources to pay for public expenditure in real terms and, at the same time, there will be a squeeze on households.

The key challenge—I guess that the chancellor was wrestling with this—is how we grow our economy out of that. If productivity growth is weak, what can we do to boost productivity and restore the public finances to health? Growing revenues in the long run is crucial, which partly explains the new investment that the chancellor announced through the productivity plan, new support for research and development and so on. The next couple of years, on both the household side and the public spending side, will be quite challenging, and it will be interesting to see what happens.

**James Kelly:** To return once again to the overall size of the budget, looking further down the line where there are cuts of £800 million for the year that is specified followed by further cuts, what are the taxation options to mitigate those cuts?

We have seen one view this morning in the Institute for Public Policy Research report, which suggests that a 3p tax rise is necessary to mitigate the cuts. What are the potential options? How much would different taxation policies raise in various scenarios?

**Professor Roy:** We now get into the question of what the Scottish Government could do with the new tax levers that are being devolved from April. On paper, the Scottish Government will have quite a bit of discretionary power to do things differently. For example, 1p on income tax will raise approximately £500 million, so if it is facing an £800 million cut, an increase of 1, 1.5 or 2 per cent in income tax would, in real terms, be sufficient to compensate for that.

Whether the Government wants to do that is ultimately a political choice. Obviously, that needs to be balanced with the outlook for the economy. If the economy is going to be slightly more fragile, the Scottish Government will face challenges from the potential economic impacts of increasing income tax. There is a lot of uncertainty in that respect—we genuinely do not know what the implications of using those devolved powers will be for the economy. On one hand, there would be concerns that that could lead to a slower economy relative to the rest of the UK, which would have implications. On the other hand, it might be a way of increasing revenue, which could then be spent on public services and would bring its own positive boost for the economy. What to do is a difficult choice, and ultimately a political choice, but the choice is now there—that is the key point. The Scottish Government now has an opportunity to take different tax decisions if it wants to in order to make up for some or all of the drop.

**Dean Lockhart (Mid Scotland and Fife) (Con):** The chancellor mentioned that he wants the UK economy to be match fit, and there was a real focus on productivity growth in his autumn statement. Productivity is also a priority for the Scottish Government. As things stand, Scotland remains in the third quartile for productivity, roughly 25 per cent behind Ireland, Denmark and some other countries. With an additional £800 million capital spend coming to Scotland, how do you recommend that should be spent to boost productivity? What other policy steps could the Scottish Government take to boost productivity in the short and medium term?

**Professor Roy:** Far be it from me to give a policy prescription for what the Scottish Government should do. There are a few points in there. To return to my point about the importance of productivity, it is crucial for what happens to future tax revenues not only in the UK but in Scotland. One of the reasons why the UK public finances have been disappointing and not as healthy as the OBR has consistently predicted over the years is not because the Government has not made the spending cuts—although it has not delivered in some areas of welfare and has moved back on that, it has actually delivered most of the spending cuts by department—but because tax revenues have been a lot lower than would have been expected, and that comes through productivity. For more than 10 years now, we have not had productivity growth at the long-term average that underpins the OBR's forecast going forward—it assumes that we will get back to that point, but we have not been there for 10 years.

One of the key risks in the forecasts, which the OBR acknowledges, is that if productivity does not get back to where it was, the deficit will be a lot worse. That is one of the things that is motivating the chancellor to make investments in those areas. We know that our productivity performance in Scotland has been a challenge for a number of years. We have caught up, in part, with the rest of the UK, but the UK lags behind everybody else, so we need to do more. The new capital investment provides an opportunity to that. You have got an £800 million cumulative increase in capital investment, plus the £450 million per year additional capital that you can now put into investment from the new borrowing powers. You have an opportunity, particularly on the infrastructure side, to look at how you can increase that expenditure and therefore boost the economy.

**Ash Denham (Edinburgh Eastern) (SNP):** The UK Government said in the autumn statement that it wanted to achieve a step change in productivity, but it matched that with an investment of 0.2 per cent of gross domestic product. Is it possible to get a step change in productivity with such a small investment?

**Professor Roy:** We worked it out and it was about 0.25 per cent, which is essentially the value of the national productivity investment fund divided by the share of the economy. If we consider that UK productivity is about 20 per cent lower than some of our key competitors, that puts it into context. In that regard, it is a relatively small stimulus to tackling the issue.

On the other hand, public sector investment is up to a relatively high level in historical terms, so it is a bit of a mixed bag in that regard. Much will come down to how the investment is delivered—we await some of the detail behind that. Last week, we heard about ambitions by the UK Government to spend an extra £2 billion on R and D by 2020-21. We do not know what that would look like and how much of that will be to replace potential European funding that is lost. Is it net additional money? The ambition and the rhetoric are there; the question is, what will be delivered and whether the measures will have an impact.

I should caution that some of the numbers that have been included in the national productivity investment fund are for things such as housing. Again, that number could be slightly inflated because there is some evidence that housing, better access and better links to work and so on improve productivity but the link is more indirect than in other areas, such as R and D and infrastructure.

**Ash Denham:** In an answer to Dean Lockhart you said that the UK is seriously lagging behind in investment. Is that just because we spend less on it? Could you put that in a European context? What percentage of GDP would an average European country be spending?

**Professor Roy:** It varies. You have to be slightly careful about making direct comparisons, because people measure things slightly differently. The UK has typically spent less on investment than most of our competitors, on both the public and the private side. We have good-quality infrastructure, but we tend not have a lot of it. That is particularly an issue around transport, for example. I will avoid saying anything about trains.

With Brexit happening, we think that the headwind will be there. Most people, whether they think that the headwind will be really strong or slightly less strong, would accept that Brexit will be a challenge, at least in the short run. There is a valid debate about the scale of that challenge.

The solution to that is what we do about productivity. As I mentioned, the UK's productivity performance in the past few years has been quite dire. Long-term productivity through the second half of the 20th century was round about 2.5 per cent, whereas last year's productivity was about 0.8 per cent and the year before it was about 0.7 per cent. It is really quite weak, so the key thing will be how we can tackle that and boost it, which in turn will feed through into growth.

**Neil Bibby (West Scotland) (Lab):** You said that the main focus of the UK Government's productivity investment fund was housing, transport, telecoms and R and D. Following on from Dean Lockhart's question, could you say whether there any areas that the Scottish Government focus on in passing on any Barnett or capital spending consequentials? Should we look for a different balance in any of those expenditures? We have recently heard from Professor Anton Muscatelli about the need to increase R and D expenditure and from others about the importance of all those areas.

**Professor Roy:** There are a number of areas that I think the Government will be looking at over the next few years. In particular, it will look at innovation and what more can be done to stimulate R and D in a Scottish context—especially links with universities and how we can increase interaction between the university sector and business. We know that transport infrastructure has strong links to productivity. With this additional money, I am sure that the Government will be looking hard at what issues that are unique to Scotland need to be addressed and where the potential real benefits will come from. I guess that that is the benefit of devolution. With this additional money, we now have the opportunity to identify the priorities in Scotland and to see where the key elements come from that.

Some of the interesting things will be around digital—we have been there before. We know that that is going to be crucial in the long run. It will be crucial for the Government to think about how it delivers its digital plans, whether it needs to tweak those, and whether any additional money can go into them. Given the priorities that the UK Government has set out around productivity and making that its flagship element, it will be interesting to see what the Scottish Government does with the additional money that is coming for capital spending. Either it will follow suit or it will take a different path.

**Adam Tomkins (Glasgow) (Con):** Could I ask a very quick supplementary question on that? It may be an unfair question, but what do you mean by "infrastructure"? In an answer a few minutes ago, you seemed to imply that housing was different from infrastructure, yet it is often rolled up into that. Do you mean roads, or digital connectivity, or something else?

**Professor Roy:** What I meant was that infrastructure classifies a broad area from housing through to transport. My point was that we know that some areas of infrastructure have a much more direct causal relationship to the economy than some other areas do, and the impact between investment in those areas and boosting the economy happens over a much shorter time period. For example, something like housing has more of an indirect but very much a long-term impact on the economy—particularly around inclusive growth and boosting the productivity of households and so on. Ultimately, the Government will face the choice of investing in infrastructure that has a more immediate, direct link with the economy, or in something that has a longer-term, more indirect effect. I was making the point that, within that classification of national productivity, there are a lot of things that capture both direct and indirect effects.

**The Convener:** It is a very interesting area. What about energy efficiency measures, which can help those at the lower end of the social spectrum and have an impact on growth?

**Professor Roy:** Very much so. With such measures, there is a capital element, a boosting growth element and a direct effect. There are also long-term effects from greater efficiency. When the Government publishes the budget and when it makes those choices, it will be useful if it sets out exactly how it believes that it is impacting both the economy and inclusive growth, so that we have the full justification for what it is doing.

What we had last week from the UK Government was quite a lot of ambition, and some numbers attached to it, but, understandably, less yet on the specifics and about how it would implement that. That is where it would be interesting to see what the Scottish Government does, too. It could be on energy efficiency, on housing, or on transport, but that setting out of where the choices are will be crucial.

**Ivan McKee (Glasgow Provan) (SNP):** There are a couple of things that I want to explore a wee bit further. I will perhaps take a step back. We are talking about numbers that are based on OBR forecasts, but clearly the OBR forecasts are based on assumptions, and I want first to explore some points about those.

We are talking about an extra £120 billion of borrowing, but then you say that that is potentially optimistic, compared with some of the other forecasts, and that the OBR has clearly made some assumptions on the type of Brexit and other matters. What is your understanding of the information that the OBR had in making those decisions? What kind of ranges are there? If we have a different type of Brexit, how much worse could things be?

10:00

**Professor Roy:** There are two points to make on that. One is about the OBR's forecast in the short run and the other is about what might happen in the slightly longer term.

The OBR, in pretty much the same way as most other forecasters, has assumed that next year the economy will slow down in relative terms, because business investment is likely to be lower as a result of the potential uncertainty around Brexit, and because consumption will fall as a result of higher inflation feeding through to real incomes. That will lead to slower growth relative to others over the next couple of years. The OBR forecasts growth of about 1.4 per cent next year, 1.7 per cent the following year and then back up to 2.1 per cent the year after that. To put that in context, the Bank of England is forecasting 1.4 per cent next year, but only 1.5 per cent the year after and then only 1.6 per cent the year after that, so there is a significant difference between the OBR and the Bank of England. Ultimately, there is a lot of uncertainty about the forecasts but, if the Bank of England forecast were to turn out to be correct, that would obviously lead to weaker growth, higher unemployment and weaker public finances, and therefore the OBR will have to address that.

That is the position in the short term. There is a really interesting part in the OBR report, buried away in one of the annexes, where it models what might happen under different scenarios of productivity performance. As I mentioned, the OBR assumes that productivity will return to trend by the end of the decade and into the 2020s. It assumes that productivity will grow by around 2 per cent, and that is the number that drives the reduction in net borrowing over the next few years, taking public sector net borrowing to about £20 billion. Interestingly, the OBR also runs a scenario for what happens if productivity does not rise but stays the same as it was last year. Under that scenario, instead of borrowing about £20 billion, we would be borrowing £50 billion. The crucial point there is how the economy does. If the economy does not perform as well as the OBR hopes, it has a scenario in which borrowing rises to £50 billion. Of course, productivity could return and could be slightly higher. We could get a bounce back and the economy could grow significantly over the next few years. Under that scenario, the OBR believes that the deficit will be eliminated and we will actually be running a surplus.

There are two crucial points. One is about the outlook for the economy in the short term. There is a lot of uncertainty about that and about who is right—the OBR, independent forecasters or the Bank of England. Setting that aside, there is an issue about the long-term trajectory for the UK economy. That is the key thing that will drive the public finances in the medium to long term, and it is arguably the most important thing to focus on.

**Ivan McKee:** Yes but, even in the short term, it looks as though the forecast could be optimistic, given some of the other ones that are out there.

**Professor Roy:** The OBR has been clear that it is more optimistic than the Bank of England and slightly more optimistic than the average of independent forecasts. To be fair, most forecasters have been revising up their forecasts, particularly for 2016, so there is a lot of uncertainty. It is based on assumptions and a judgment call on what assumptions to put into the forecasts. The OBR is clear on what it does and does not model around Brexit. In essence, it just takes what is in the public statements of the UK Government and models that up. It assumes that the UK leaves in 2019, and that that has an impact in the period up to then, but it does not assume anything beyond that about future trading relationships. Clearly, that will have an impact on future growth and public finances.

**Ivan McKee:** I also want to explore population assumptions, which I am a wee bit confused about. The UK population has been growing, with net migration at 350,000 a year or thereabouts, which is about 0.5 per cent of the population and which is a fairly chunky number. A big part of the vote for Brexit was on the assumption that that population growth and migration would be brought "under control"—to use others' words—and would reduce to the low tens of thousands. If we assume that that is true, we cannot also assume that we will return to a 2 per cent plus GDP growth rate and that productivity will stay at the current low levels, because those cannot all be true. Either the population growth is going to stay at the current level—in which case, what was the point of voting for Brexit?—or the GDP growth numbers are overoptimistic by at least 0.5 per cent, or something is going to happen in productivity over the next few years that will be magicked out of nowhere. What is your comment on that?

**Professor Roy:** The OBR assumes that there will be a hit to productivity over the next couple of years but that it will return to the long-term trend towards the end of the forecast period.

The OBR had been planning to increase its forecast for migration towards the end of the forecast period relative to what it had forecast in March, because migration had been much higher than previously. The OBR now assumes that, because of Brexit, that increase will not happen. Migration into the UK is still built into the OBR's scenario planning, but the OBR has reduced the forecast. However, it still assumes that there will be positive net migration into the UK.

**Ivan McKee:** At a similar level to just now.

**Professor Roy:** Yes.

**Ivan McKee:** But not increasing, as it might have done otherwise.

**Professor Roy:** Yes. Migration had been higher, so the OBR was planning to increase its forecast. However, it is not doing that now but is keeping the forecast the same as the previous forecast. The OBR is therefore still forecasting positive net migration, but it is not as high as it would have been if the UK were remaining in the EU. The OBR also increased the forecast for productivity back up to 2 per cent at the end of the period. Those migration and productivity forecasts are the key drivers that influence the OBR's GDP forecasts.

**Ivan McKee:** If migration were to drop to the numbers that Brexiteers have assumed—the low tens of thousands—the OBR's numbers would not hold up.

**Professor Roy:** Yes. If we changed the migration assumptions by lowering them, that would naturally reduce the GDP forecast. However, to be fair to the OBR, it has tried to be as neutral and balanced as possible about the things that are driving the forecast, so it has not assumed changes in migration, changes in trade relationships or changes in how those trade relationships feed through to productivity. When the Brexit deal is finalised, the OBR will ultimately have to change its forecasts. One of the key points for the forecasts for both the economy and the public finances is the highly significant level of uncertainty in all of this.

**The Convener:** Am I right to say that, under the most pessimistic forecast, there could be £220 billion of additional debt by 2020 from a hard Brexit? I think that that was the figure that the OBR gave.

**Professor Roy:** Yes, but within that there are a couple of numbers flying around that are slightly confusing. On its current assumptions, the OBR is forecasting that there will be £120 billion of additional borrowing over the next few years. Some of the forecast increase in debt of over £200 billion comes from classification changes, such as some of the money that the Bank of England uses being reclassified as public sector money, which adds about £100 billion to the debt. Therefore, one of the reasons for the net debt figure increasing significantly between the current forecast and the previous one is a classification change. However, the key number to focus on is the £120 billion, which is the additional borrowing relative to what had been planned over the next few years.

All of this will have to be revisited, though, because the OBR has not made a long-term forecast for what Brexit might look like. Whether there is a hard Brexit, soft Brexit or middle Brexit, the OBR will have to look at its forecasts again.

**The Convener:** Oh, boy. [*Laughter.*] Willie, do you want to ask a supplementary question?

**Willie Coffey (Kilmarnock and Irvine Valley) (SNP):** Aye, just on the general borrowing and forecasting stuff. Professor Roy, one of the slides in your submission to the committee has some key messages. One of them is that £120 billion of additional borrowing is forecast, of which only £23 billion is due to policy announcements. My arithmetic tells me that that is £97 billion of additional borrowing and that a substantial portion of that is attributable to Brexit. Can you give us a wee flavour of what that borrowing is for? Why are we borrowing that amount of money? What kind of impact will it have on the overall national debt?

**Professor Roy:** The £120 billion of additional borrowing is the cumulative borrowing between now and 2021, relative to what the chancellor had forecast in his budget back in March. You are right: the OBR has attributed £60 billion of that to

Brexit effects, and £23 billion to £25 billion of it relates to policy. Interestingly, around a further £25 billion of it is just for a general weakness in the economy beforehand. Tax revenues have been disappointing in 2016-17, and the OBR expects that to continue. Even before Brexit, borrowing was going to rise relative to what had been planned, and the remainder is a difference between classifications about borrowing and where it comes from.

Essentially, the OBR has set out where it thinks that additional £60 billion will come from—where the different sources of that kick through. The two key points to look at are what the OBR thinks will happen to tax revenues because of business investment leading to lower growth in the economy, which in turn leads to lower long-term growth in revenue from corporation tax, national insurance, income tax and so on and, crucially, the forecast of lower consumption in future, which in turn feeds through to lower tax revenues. Cumulatively, the OBR has revised down its income tax revenue forecasts by around £66 billion. That is quite a significant downward revision to tax revenues.

Essentially, the key driver of the £60 billion increase in borrowing is a slower economy, leading to slower growth in tax revenues, which, in turn, leads to higher levels of borrowing.

**Willie Coffey:** The slide refers to a

"Substantial deterioration in public finances",

with an implication of

"lower wages, employment and living standards",

as well as

"Significant downward revisions to forecast economic growth".

Another slide says that, of

"12 fiscal rules since 1997",

there are

"10 broken or abandoned".

That is hardly an encouraging picture for Scotland on St Andrew's day, is it? Am I right in saying that the overall national debt is heading towards the heady total of £2 trillion?

**Professor Roy:** Thankfully, those numbers are not my numbers today, so I am not the one giving you the gloomy news.

The previous chancellor had a plan to restore the public finances back to balance. There was obviously a debate about whether that was the right or wrong thing to do. That was going to be tougher in any case, because tax revenues were not performing as well as had been planned even before Brexit. We now add in the downward revisions that have been made to the economy—to living standards and earnings—as a result of the referendum outcome. That means that meeting those public finance targets becomes much more challenging. There is an increase in borrowing. Instead of running a surplus of £10 billion, the chancellor is now running a deficit of £20 billion.

Debt is now higher. It is rising towards 90 per cent of GDP. In turn, that means that the fiscal rules have been broken—again. Quite a number of fiscal rules have been broken. The chancellor now has a new set of fiscal rules. Rather than constraining public spending, they are more about giving him some headroom to do that. He has left about £26 billion of additional stimulus that he could use if the economy slows worse than he expects. Ultimately, that has led to a set of weaker public finances.

It is a matter of the budget continuing to be cut up to 2021. Even then, the repair job is probably not likely to have been completed, and there will potentially be further cuts or consolidations into the 2020s as the Government tries to restore the public finances back to balance. That is what it said its overall objective would be: to run a balanced budget at some point in the next Parliament. There is a debate about whether that is a good thing to do, but that is what the Government plans to do. That would imply further real-terms cuts to public spending.

**Willie Coffey:** Is there any good news anywhere on the horizon? Even one bit?

10:15

**Professor Roy:** The big thing, to be fair, is that the economy has held up much better than expected in 2016 compared with what most forecasters had predicted. There were three key things about how Brexit could have an impact on the economy. One was the potential for a short, sharp impact on uncertainty that could come from a shock result. In the couple of months after Brexit, there was a quite significant risk that the economy could slow down really quickly in 2016. There would then be the adjustment phase as we travel to the new world; even the people who supported Brexit said that there would be some challenges as we go through that adjustment phase. There is much more debate about the potential longer-term impacts on trade from Brexit; the people who supported Brexit see it as an opportunity.

The positive bit comes in the first part; the level of uncertainty feeding through to the economy—at least in the immediate term—has not been as significant as it could have been. That showed that the economy had slightly more momentum through the start of 2016, and that the economy was slightly more resilient, than had been thought. The sharp drop and depreciation in sterling has also fed through to some positive impacts on exporters. Those are the key positive things that I focus on.

**The Convener:** Now we have got past I M Jolly, I call Patrick Harvie—not that he will be any worse. [*Laughter*.]

**Patrick Harvie (Glasgow) (Green):** To be honest, I think that Willie Coffey's voice sums up the way that a lot of people feel about everything that 2016 has already thrown at us.

Good morning, Professor Roy. A few members want to discuss distributional and social justice impacts. I want to try to link to those from the discussion that we have had about debt and productivity. If we assume that, at some point, the UK Government gets to a surplus and starts reducing public debt—you have acknowledged that there is a debate about whether that is advisable in principle—is it fair to say that, if there has not also been a significant increase in productivity, a reduction in public debt can only lead to increased levels of private debt in the economy?

**Professor Roy:** Yes—unless the Government continues to cut through public expenditure or increases tax revenue. The way to reduce debt is either through growing more quickly on the productivity side or continuing to cut. Where does the growth come from to reduce that overall debt? It comes from becoming richer and being able to pay off more, or it comes from either further cuts or increases in debt somewhere else—and that could be higher levels of private sector debt.

**Patrick Harvie:** The story that we have seen since the financial crash is a significant increase in household consumer debt. By one estimate, it has gone up by 65 per cent since pre-crash levels, and a lot of those affected are the people who have been hit by austerity decisions on pay levels, meeting basic needs or welfare cuts. That private debt is also more expensive than public debt.

Can the Fraser of Allander institute do anything to give a clearer picture of the impact that any further increases in private debt will have on social justice arguments and the condition of the economy? We often think about that distributional impact purely in terms of direct changes in tax and welfare rates, but when we push people further into desperation, we also push them further into private debt and that will be more expensive for them in the long run.

**Professor Roy:** That is a very good point and we would definitely be keen to look at that issue. It is probably a weakness in much of the discussion about the outlook for public finances that it focuses on the public finances and not on the wider implications for the economy. Some of the unintended consequences of that are that debt is pushed off balance sheet and then comes back on to balance sheet; for example, the Bank of England's asset purchase facility is now coming on to the public sector balance sheet. That adds about 10 per cent to GDP.

There is a whole debate about what is genuinely the ultimate debt of the economy. At the moment, we tend to focus on the public finances. I think the point is really well made; it is about looking at the debt not just on the public sector side, but on the private sector side.

**Patrick Harvie:** By any estimate, private debt is much larger than public debt.

**Professor Roy:** Oh aye—by a massive amount. We then get to a really crucial point. One of the implications of the autumn statement was that slower growth is coming through lower productivity, which in turn leads to lower earnings. With higher inflation, that creates a dangerous cocktail: relatively slow growth in real earnings, which feeds through to relatively low levels of household income, which puts pressure on households and—you are right to say—potentially leads to higher levels of private sector debt. All those things are essentially ignored in the type of analysis that we currently produce and elsewhere.

You make a good suggestion that we need to link all the elements with what is happening on the private sector side with regard to the distributional impact and the debt impact. We will look at that.

**Patrick Harvie:** Thank you.

Moving on to the way in which the impacts from the direct changes in the autumn budget statement are distributed throughout society, I have a couple of charts in front of me. The first chart, which is from the Scottish women's budget group, demonstrates not only that the impact is more severe on the poorest third and least severe on the richest third, but that at every level throughout the income distribution, the impact is more severe on women than on men.

The second chart, which is from the Resolution Foundation, shows the distributional impact of the 2016 budget in comparison with the impact of the changes proposed in the autumn statement. It is clear that the changes in the autumn statement are marginal in comparison with the hit that people were already taking from tax and benefit policies as a result of the 2016 budget. Admittedly, people in the top decile were a little bit worse off following the previous budget, but only by a tiny proportion of their actual income, while the rest of the top half of the population were significantly better off and the deepest cuts were hitting the poorest third of society.

Do you recognise and endorse the Resolution Foundation's assessment? The ultimate question is, what can we do about that with the choices that are available to us through the Scottish budget? Is it possible for Scotland to change that line at all and make a more significant impact in protecting those who have been hit so hard by UK Government decisions?

**Professor Roy:** I do not have those specific charts in front of me, but I recognise the various bits of analysis that people have done. Obviously, it depends on what the starting point is and who wins and who loses and so on. For example, would you start from the beginning of the consolidation period or from the autumn statement?

You are right to say that the autumn statement did not contain many new measures for changes in welfare or taxation that would have an impact on the people and households on the lowest part of the income distribution scale. However, the freeze to working-age benefits, which we knew would be crucial going forward, is the key driver in the challenge for people in that part of the income distribution scale over the next few years. Higher inflation will make that challenge even harder. If we add to that the fact that earnings are now predicted to be slightly lower than they would have been, and that inflation is eroding those earnings, we see quite a pinch point over the next few years for people in that group in society, who are facing the full impact of higher inflation on their earnings and in the freeze on working-age benefits that is coming through.

There was a great deal of speculation that the chancellor might do something to address that. What he did was to make a minor change to the taper rate for universal credit. It is a relatively minor change in comparison with all the other changes that had been planned to save some money, and it does not kick in until quite a bit further down the line. We know that the roll-out of universal credit keeps on being delayed, so any changes to it are not likely to have an immediate impact on the vast majority of people who receive working-age benefits until towards the end of the forecast period.

I do not have the charts to which you refer in front of me, but that kind of analysis is consistent with our conclusions. We then get into the question of what policies the Scottish Government can implement to mitigate the impact. There is a lot of debate about what it can do around the personal allowance, such as whether it can set a 0 per cent rate on top of that to increase the personal allowance.

To be honest, that is not a tax policy that impacts on people at the lowest part of the income distribution. Most people there are not paying income tax because of the various deductions. It would have much less of a blunt effect than expected. People in different parts of the income distribution use certain types of public services more often than others. That is potentially where to look for mitigating action that can be taken to support people at different parts of the income distribution.

Local government is crucial, because it picks up quite a lot of the anti-poverty measures and the implications in terms of education. There are potential mechanisms in those areas that the Government might want to look at, for example offsetting some impact by directing resources at the public services that the Scottish Parliament controls.

**Patrick Harvie:** It is interesting that you mention the personal allowance as one option. The next graph in the Resolution Foundation report demonstrates that 85 per cent of the benefit of the change to personal allowance goes to the richest half of the population. The notion that increasing the personal allowance is a socially progressive measure does not stand up to much scrutiny. Would we be able to have a more positive impact on the curve of who benefits and who carries the greatest burden if we were willing to look at the tax rates rather than the allowances and thresholds? We could reduce the rates for those on a below-average income and increase them for those who can afford to pay more.

**Professor Roy:** You are right: the personal allowance essentially benefits individuals and does not impact on a household basis. The vast majority of the impact is at the higher parts of the income distribution. You are talking about what you might do with the rates to raise income and feed that through to use of public services. That is one way to do it.

Whether you could cut rates, for example, to boost the incomes of marginal households comes back to the point about the personal allowance. Cutting tax rates is not likely to make an impact on the households that are most impacted by the welfare cuts and in the first few deciles of the income distribution. If you cut the basic rate, that benefits everybody. You have to be careful about how the rates are used as well.

**Patrick Harvie:** That is assuming that we have only one basic rate, as it stands at the moment.

**Professor Roy:** Exactly.

**Patrick Harvie:** Which is not required under the new powers.

**Professor Roy:** It is not. My point is that, if you focus on the households in the first few parts of the income distribution, cutting the rates or changing the allowances is not likely to have much of a direct impact. Targeting public spending on such households could be the most crucial action.

**The Convener:** I am sorry that it has taken a while to get to Maree Todd.

**Maree Todd (Highlands and Islands) (SNP):** Professor Roy has covered much of what I was going to ask very well.

The Finance and Constitution Committee's job is to scrutinise the Scottish Government. We try to match up policy aims with spending and see how that works. It is not our job to scrutinise the UK Government, but I was struck by what you said about how the hardest hit will be the poorest in society—working-class families and those on low incomes. How does that match up with the promise to be a Government that delivers for working-class families?

**Professor Roy:** I do not want to comment too much on UK Government policy. The UK Government would be able to articulate a strong answer on that. The chancellor faces a difficult balancing act on growing the economy, and the UK Government's view will be that a faster-growing economy that has stable public finances will, in the long run, be the most important for boosting growth. That is a political argument and, whether you agree or disagree with it, it is ultimately a choice that the Government will make. Our focus will be on the analysis about the autumn statement—for example, who is impacted most. Whether the decisions are right or wrong, and whether they represent the right or the wrong way to do things, are ultimately political choices.

10:30

**Maree Todd:** Clearly, some people will be impacted severely next year when inflation peaks.

**Professor Roy:** Yes. That is the big thing that is pretty much guaranteed. Obviously, lots of things about the forecast are quite uncertain, but when there is a 15 per cent depreciation in the currency, that will feed through to higher import prices, which in turn will feed through to higher inflation, which will impact on different households. Therefore, when the choice was made to freeze working-age benefits, because inflation will be higher, that will impact on more people than would otherwise have been the case. Pensioners, on the other hand, are more protected, because pensions are linked to overall inflation. There will be differences in distributional impacts but, ultimately, it comes down to what you want to do with the choices.

**The Convener:** Dean Lockhart has a supplementary.

**Dean Lockhart:** It is on a related but slightly different point. The chancellor has said that he will look at the measure of budget deficit as a percentage of GDP. At UK level, that is 4 per cent, and the target is to reduce it to below 1 per cent by the end of the UK parliamentary term.

The latest "Government Expenditure and Revenue Scotland" figures show a notional budget deficit in Scotland of about 9 per cent. What impact will the budget deficit and the additional borrowing powers that are coming to Scotland have on that notional budget deficit level? Do you expect that 9 per cent number to increase or decrease over time?

**Professor Roy:** I always love a question on GERS. Essentially, GERS assigns expenditure and an estimate of revenues in Scotland, as well as a share of equivalent UK expenditures. Any up or down movement in the UK deficit will feed through to the Scottish budget and make it move up or down. If the UK Government continues to cut the fiscal deficit, we would expect the Scottish fiscal deficit to decline, too. Within that is the debate about relative shares of oil and what might happen with all that other stuff. However, if we just take the onshore economy, if the UK deficit is falling, the Scottish deficit will fall as well.

**Dean Lockhart:** But that would be subject to additional borrowing by the Scottish Government, if it were to use its new powers to do that.

**Professor Roy:** The number that you are talking about in GERS—the 9 per cent and so on—is the notional Scottish position within the UK context. It does not have too much to do with the Scottish position under the fiscal framework.

If the Scottish Government were to increase capital borrowing, that would add to the overall public expenditure. However, it is slightly irrelevant in the GERS context because, ultimately, the Scottish Government does not run a deficit; it has a balanced budget. GERS is a slightly different concept of what a fiscal position might be overall.

**The Convener:** I will change the focus from the chancellor's budget and how we might deal with it in the Scottish context to more of a focus on how the committee and the Parliament deal with budgets. That is crucial, because the autumn statement included an announcement that the UK budget—the main fiscal event—will move to the autumn. Dealing with the ramifications of the timescale change will put significant pressure not just on the Scottish Government, but on the Scottish Parliament. We were talking about big changes under the budget review group, but a radical change will be needed to deal with the new timescales.

**Professor Roy:** The fact that the main budget statement will be in the autumn is, in some ways, helpful in that regard, because there will no longer be a situation in which the Scottish budget is set, it goes through the process in January or February and then the UK Government can make major fiscal changes in March, less than a month away from when the Scottish budget kicks in. That is a positive.

However, the challenge relates to when in autumn the budget statement will be. The definition of autumn in the civil service seems to range between July and December. The date will be the crucial point. I would not expect it to be that early in the autumn. The UK Parliament returns later than the Scottish Parliament and there is then the UK party conference season, which is around October. The budget statement might not happen until sometime in November, which immediately means that there will be challenges around when the Scottish budget will be and the Parliament's ability to scrutinise it.

If the major budget event is going to be in the autumn, it would probably make sense for the Scottish budget to come after that, given that that is when the block grant adjustment will be. However, I caveat that with a number of points. First, a lot of information could be provided in advance of the finalisation of the budgets. A lot of detail could be provided in the run-up to whenever the Scottish budget is done. Secondly, the timing of the scrutiny is important but for me the key thing is the quality of the scrutiny. That is the sort of stuff that the budget review group is looking at. I think that I am coming to speak to the group about that in the next couple of weeks.

What is the level of information that underpins the Scottish budget? How transparent are the assumptions that go into it? How transparent are the various elements of portfolio spending? If the budget scrutiny period is slightly shorter than it has been in the past, how can we improve the level of scrutiny without trying to find lots of different material from different places? Some quite significant issues arise not just about the timing, but about the quality of the scrutiny. If the scrutiny is going to be constrained by the timing, we need to improve the quality.

**The Convener:** The Auditor General suggested the need for a medium-term financial strategy from the Scottish Government. If that was to become a feature of the process in Scotland, what level of information would there need to be in that financial strategy to allow that scrutiny to be undertaken at an appropriate level?

**Professor Roy:** There are two points to consider around that. One is that you have to move beyond one-year budgets. Murdo Fraser made the point that the budget next year will rise in real terms. In a sense, there is a danger that that pushes back some of the difficult decisions that have to be made, because if only a one-year budget is published, those difficult decisions are hidden to an extent.

At the very least, you need to be setting out budgets up to the end of the parliamentary session. The OBR has a rolling forecast period—every time that it comes to an update, it adds on an extra year. That is crucial. You should be looking at forecasts for five years out, not just on your spending elements but on your revenue elements. There will be uncertainties about that but there is an advantage in being up front about the uncertainties, which the OBR has done this time, and being clear about where the various expenditure pressures will be. Acceptance that we need to have multiyear budgets to help with planning and so on is where we need to move to in the budget process.

The second point is about what we do about the medium to long-term challenges around the budget. The Auditor General is quite right in that we know that things such as demographics in particular will start to have quite a significant impact on pressures on certain elements of public spending over the next few years.

The OBR says that the deficit will be about 0.8 percentage points higher in the mid-2020s because of demographic pressures. That is quite a significant increase in spending that we need to get to. It would be really helpful when you are making commitments to protect the health budget in real terms, for example, to think about what that means in the context of an ageing population. How can you forecast that need? What might the pressures be further down the line from medium to long-term implications?

**The Convener:** Professor Roy, thank you for coming along—it has been a very interesting session.

10:38

*Meeting suspended.*

10:44

*On resuming—*

## Taxation Inquiry

**The Convener:** Item 3 is evidence for our taxation inquiry. We will hear from Yvonne Evans, who is on the tax law sub-committee at the Law Society of Scotland; Alan Barr, who is a partner at Brodies LLP and an honorary fellow at the University of Edinburgh, although today he is speaking mainly in a personal capacity; and Professor David Bell, who is a fellow of the Royal Society of Edinburgh. I warmly welcome our witnesses. Committee members have received papers from each of them, for which we are grateful.

If a question is directed at one particular witness, the others should not feel constricted by that. If you want to contribute, let us know. We will try to make the discussion as free flowing as possible. Nobody wants to make an opening statement, so we will get straight into questions, beginning with one from Adam Tomkins.

**Adam Tomkins:** I should say that I am also a fellow of the Royal Society of Edinburgh, but I am not a member of the working group that David Bell has been part of.

There is a very strong suggestion in the evidence from Alan Barr, the RSE and others that so far the use of devolved fiscal powers has been a bit disappointing and lacking in imagination. Do you all agree with that? If you do, does it reflect a failure of political imagination on ministers' part or is it, perhaps more disturbingly, a reflection of a lack of capacity on the Scottish Government's part?

**Alan Barr (Brodies):** It is a combination of the two. In the end, it is a matter of practicality. In relation to the devolved taxes there was a need to get legislation on to the statute book and to start collecting tax. That is a long and difficult process, so the understandable main route was to work on the UK taxation model that was there. In other words, the prime revenue-raising tax that is wholly devolved—land and buildings transaction tax—was based entirely on a stamp duty land tax model, and it was understandable that it was based pretty much on the UK model. I would not necessarily have started from there, but ministers did, and I understand the necessity of doing so.

Doing it differently would have required a much greater preparatory effort in terms of the economics of what the tax would raise and whether it would be attached to transactions at all, or even whether it should have been approached from an entirely different angle. That would have been harder and would have taken more time, so I understand why it was done in that way. Was it possible to do it differently? Yes, of course, but I fully understand why that did not happen.

**Professor David Bell (Royal Society of Edinburgh):** A principle of a well-functioning tax system should be transparency. We should not expect things to change rapidly. If we move away from the current Westminster model of changing taxation at relatively short notice without having wide and informed consultation before that happens, we run the risk that the tax system will lose some credibility. I have not been particularly concerned that a small change has been made in the structure of LBTT, but we are certainly of the view that, as far as the approach to taxation is concerned, a transparent structure would involve wide consultation, and you cannot expect that to result in rapid changes in tax structure.

**Yvonne Evans (Law Society of Scotland):** I agree with that. We do not want change for change's sake. If there is going to be change, we want it to be considered and carefully thought out. Perhaps slow change is easier to manage, because certainty is a very important principle in tax. It is perhaps more manageable to start small.

**Adam Tomkins:** There is a power on the statute book—section 80B of the Scotland Act 1998—that is not a Smith commission power but a Calman commission power. The provision, which was introduced by the Scotland Act 2012 and has been in force since 1 July 2012, gives the Parliament the power to create new taxes, but it has never been used and nobody ever talks about it. Should it be used? Should we talk about it? Would that be a way of having a more imaginative discussion about fiscal devolution?

**Alan Barr:** Certainly, the easiest way to get more imaginative solutions would be to start from a new taxation base. Then you would not be trammelled by the Westminster model, either in the form of legislation or what it was attempting to tax.

There is a slight danger of taxation for taxation's sake—the idea that we have a new toy in the box, so we are going to use it. That seems equally dangerous, but it would be possible if there was a policy or an economic desire to tax a particular thing. The policy of simply raising money might not be enough—tax is much used as an economic lever, so it could be done for both those reasons. However, I can understand why it is not being done: it is hard—these things are difficult.

**Professor Bell:** I agree that we should be opening up the debate. We have had the opportunity for some time to discuss the structure of taxation in Scotland. We cannot do that without recognising that we are part of an existing UK structure that is incredibly complex. Finding a way through that to determine a different path for Scotland is in itself not something that can be done quickly or lightly.

We do not discuss charges very much, either. Taxation and charging for services should not be viewed as completely distinct. For example, local authorities charge a lot for long-term care. There are taxation alternatives to the charging route, but these issues seem not to have been all that high profile in the public discourse in Scotland over the past few years.

**Yvonne Evans:** I would support all those comments on new taxes or the amendment of existing taxes. We can point to plenty of problems with existing individual taxes that the Scottish Parliament would have an absolute opportunity to reform for the better if it got hold of them.

On the whole tax system, however, it absolutely adds complexity if we have extra or different taxes for taxpayers in Scotland.

**Alan Barr:** It is a policy thing to start with. You have to decide whether taxes are to be used as a means of discouraging or preventing people from doing things by making them more expensive. Alternatively, there is an opportunity. Governments need money, and there is a source of money that can be raised—that will be a reason for a new tax. Sometimes those things happily coincide, but they are separate considerations.

**Adam Tomkins:** I have one more question. You should feel free to disagree with one other where you want to.

On opening, general principles, so far as I can see, nobody has mentioned the great constitutional principle that there should be no taxation without representation. Is that not a principle of Scottish taxation that we should adhere to? If it is, one question is what the justification is for business tax when businesses do not vote. Another question is whether we are confident that we have got right the relationship between the tax base—and the definition of "Scottish taxpayer"—and effective representation in Scotland.

**Alan Barr:** I do not think that I agree with you on the point that businesses do not vote. The owners of businesses vote. The shareholders, the employees and all the people who economically derive benefit from businesses have votes. It is hard to see how you would give entities a kind of supervote for their representation in any working form of democracy. On that constitutional question, we are as good as we can get. Entities do not have separate votes, and they therefore do not have direct representation.

The question about the Scottish taxpayer base is a difficult one. In a mobile situation without hard borders it is extremely hard to tie it down. The one thing that surprises me—and it is not possible to deal with this in the current devolution settlement—is that rental of land in Scotland will be taxed according to the location of the taxpayer, not the land. That strikes me as somewhat anomalous, given other policy initiatives in relation to land in Scotland. Otherwise, the tax is tied to the person, rather than the place, although the person must be tied to the place by some method or another.

My difficulty with how that is being done is that for a pretty small number of people the situation is uncertain. For most people it is very certain: they have one home location, which will define them as Scottish taxpayers or otherwise. However, for a very small number of people—ironically, it is probably those who have the most to gain or lose from flexibility—there is some uncertainty. The definition that has been adopted is the slightly woolly description of home for a Scottish taxpayer, which has also been carried over into an element of the LBTT legislation. I find that somewhat strange, because it is such a vague definition—it is basically centred on where your home might be. That taxpayer base may change in due course.

**Yvonne Evans:** I agree with that. The definition of "home" is inconsistent across different capital taxes, including LBTT, and charges. It would be helpful for you to think about that carefully and consider what you are trying to achieve and whether the tax is achieving that.

**Patrick Harvie:** I have a supplementary question. I am glad that Adam Tomkins has given us all permission to disagree with him—I will bank that for future use.

**The Convener:** I thought that he had effectively confirmed that he was supporting votes at 16.

**Patrick Harvie:** I was surprised at the idea of giving votes to businesses—that sounded more like a 2 am Donald Trump tweet than something from the usually calm and intelligent professor. [*Laughter*.]

However, Adam Tomkins was right to say that there are pre-existing tax powers that have never been used. This goes back to 1999: the Scottish Parliament has always had the ability to levy a wide range of taxes on any tax base that it wants to use, as long as that tax is being raised for local services.

There has been a reluctance to go beyond the consensus that the council tax is a bit rubbish and a bit of a broken system, and take action. Is it worth suggesting that underlying everything that we say publicly is an unspoken principle, which is that we take the path of least resistance and do what is politically easiest? I know that we will go on to discuss what the principles should be, but is there an unspoken principle that is preventing us from taking political action, even when everyone privately agrees that it is necessary to do so?

**Professor Bell:** I am inclined to agree with you. The conclusions of the Burt review, for which I did the analytical work, were dismissed almost before they hit the press. Subsequent events in relation to council tax have suggested that a very small c conservative approach has been taken to its reform. It is a political problem, rather than an economic one, but it seems to me that Scotland has not been all that radical in its tax approach, particularly in relation to the taxation of property.

**Alan Barr:** There is a danger that any new tax is simply grafted on to the current system. To be truly radical and get acceptance would require a starting point that asks, “What are we going to get rid of before we come up with something new?” It is really difficult to do that, because one has to calculate exactly what the current approach raises, consider whether more or less is needed from what will replace it, and, in political terms, think about which geese will squawk loudest because more feathers will be taken from them than was the case under the previous system.

11:00

All that is difficult stuff. If one has tax powers, including the power to introduce new taxes, the temptation is simply to say, “Let’s put a new tax on peanuts, or fizzy drinks”—or something else that has its political reasons. That creates a layer of additional complexity in what is the most ridiculously stupid, complex tax system in the world. At the moment, the Scottish element of the system is just another layer of complexity for people who are in Scotland—and if powers were used radically in relation to local authority residents, there might be yet another layer of complexity in a fundamentally stupid tax system. To introduce a Scottish addition to the stupidity just because we can does not seem to be a good way forward.

**The Convener:** Well. Silence has followed that.

**Patrick Harvie:** The suggestion was that Scotland has not been tempted to make changes. You said that there is a temptation to add complexity. When we consider the scope of devolution from 1999 onwards, it seems to me that there has been very little giving in to that temptation—

**Alan Barr:** I agree with you.

**Patrick Harvie:** In fact, we have retained outdated and dysfunctional systems.

**Alan Barr:** Whether or not they are outdated and dysfunctional, I think that they have been retained because that was the path of least resistance, as you put it. That is understandable, because to make different decisions is hard. It also requires a lot of preliminary work, and this Parliament is not so old as to have done the necessary preliminary work.

**The Convener:** It strikes me that there is a tension here in relation to the ability to make radical reforms. Income tax will be our biggest area of tax take for the foreseeable future. In the submissions, everyone talked about procedural fairness, transparency, keeping compliance costs low and so on. How feasible is it radically to reform income tax, when HM Revenue and Customs will continue to administer the process and radical reform would require the Scottish Government to put up significant money to pay for the change? How radical can we be on income tax, in reality?

**Professor Bell:** There are the administrative costs that you rightly identify. There is also the intermingling with the tax system in the rest of the UK, so there might be a behavioural response if we were to go for radical change in the bands and the rates, and the interaction with national insurance, which is another form of income tax in all but name.

There is also the fact that a lot of radical reform might involve changing the tax base, which Scotland does not have control of. It seems to me that radical change in respect of our largest source of revenue should be thought of as a long-term venture, rather than one on which we can embark relatively quickly without going through the necessary analysis, consultation and so on.

**Alan Barr:** I do not think that it would be that expensive to be radical within the current confines. In other words, there is complete control of rates and thresholds, but there is only complete control of rates and thresholds; some of the other things that are talked about in relation to the tax base, such as aspects of the definition of a Scottish taxpayer, are not devolved matters. It would be relatively cheap to diverge radically from income taxation policy in the rest of the UK, but whether that would be desirable is an entirely different matter.

We are told that the greater the divergence, the more it would cost, but that is probably not true for rates and thresholds. Much more important, in terms of administration, it will be just as expensive to make small changes as to make large changes. In many ways, it might be worse to make small changes, because transparency would be lost. It is possible to be radical on such matters within the devolved powers but, given the mobility of the population, whether that is desirable is a very different matter.

**Yvonne Evans:** I agree with that. You have very wide powers with rates and you can do what you like with them, but that is only part of the story. Not having control of the rest of the tax—expenses, reliefs and so on—will hold you back in terms of how you can shape and reform the tax more radically.

**The Convener:** There was comment in some of the paperwork about people creating corporations in order to avoid income tax. Can you talk us through the dangers of that for us if it were to become a reality?

**Alan Barr:** Yes, people could do that, but it is a constantly moving battlefield. A good example of the interaction in the way that it works is that people can take income from their own company in the form of dividends, which are not liable—and are not capable of being liable under the current rules—for the Scottish rate of income tax, however different that is. The up-front costs of converting businesses from sole trader or partnership status to corporations tend to be significant, so whether it is worth people doing that depends on the amounts involved. That illustrates the tension between the two systems. The taxation of dividends is an RUK matter; the taxation of earned income from the same company, same business or the same underlying economic activity is in the confines of the Scottish Parliament.

**The Convener:** How sensible is that?

**Alan Barr:** It is not particularly sensible to have that amount of separation. It is perhaps understandable with fluid borders.

**Professor Bell:** Tipping points that are of interest in relation to the yield of income tax include the incorporation issue. There is also the employment/self-employment border. People might be encouraged to become self-employed even though their behaviour is similar to that of an employee in reality. That is one of the reasons why, as the chancellor acknowledged in the autumn statement, income tax revenues have fallen way below expectations for this fiscal year.

The other borders that are important are the hours border, or people working less as a response to higher income tax rates; the early retiral or withdrawal from the labour market border, which can happen if people respond adversely to higher income tax rates; and, as has been mentioned, people moving to a lower tax jurisdiction. Some might find it advantageous to take that route in order to avoid higher rates of tax.

**Yvonne Evans:** I absolutely agree. The tax system creates a lot of situations in which taxpayers who seem very similar are taxed quite differently based on things such as employment status. That offends the principle of horizontal equity, as it is known. There is no clear policy reason for that and I have seen no justification that explains why it should be the case. It encourages taxpayers to choose tax motives for behaving in particular ways.

**Maree Todd:** Again, most of what I was going to ask about has already been elucidated. On the question of people being mobile and being able to change their residency, how confident are you that the current arrangements with HMRC are tight enough to identify Scottish taxpayers?

**Alan Barr:** Any tax system has to be used to identify tax connections with the people whom it wishes to tax. There are levels of that already, for example, with UK residency. Whether someone is a UK resident is a preliminary to whether they are a Scottish taxpayer, and HMRC's ability to police that is reasonable. With regard to identifying whether or not someone is a Scottish taxpayer, I stress that the number of people who have a real choice in the matter is relatively small—

**Maree Todd:** But they are relatively high contributors.

**Professor Bell:** Yes, indeed—they would be.

Other than in a few cases, there is a move away from a very objective count-the-days test, which is way down the list in terms of qualifying or disqualifying someone as a Scottish taxpayer. Those vague notions may cause some difficulties in relation to people who are effectively based in Scotland but are able to create a base elsewhere. The extent to which the situation is policed depends on the resources that are put into it, and on how soon people are prepared to challenge the position and get tax cases on the board so that people know that, if they do a particular thing, they will not be a Scottish taxpayer, and if they do not do it, they will be.

**Yvonne Evans:** If someone was caught as a Scottish taxpayer, the gain could be quite short term. If they knew that they qualified as a Scottish taxpayer, they could just counteract that by changing their practices to spend much more time in London or to address whatever element they had fallen down on in the test.

**The Convener:** Murdo Fraser has a supplementary on this area.

**Murdo Fraser:** The discussion on tax distortions and tax competition is interesting. There is quite a lot in the Royal Society of Edinburgh's submission about the interrelationship between taxes in Scotland and taxes in the UK, given that we are in a single market and given the fluidity issues that we have discussed. How much evidence is there on the impact of differential tax rates in a jurisdiction such as the one that we are moving into? How much do we know about likely changes in behaviour?

**Professor Bell:** We know a little bit—we know more at the international level than at the sub-national level. Some countries and localities that are right beside each other seem to manage quite successfully with different rates of income tax; Denmark is an example of that.

There are differences in countries such as Switzerland. I would need to go back and check this, but I think that the evidence is less clear as to the potentially negative effects of people taking actions for tax motives in that jurisdiction. There is a mixture of evidence, and my feeling is that one has to be pretty wary about applying international lessons from other jurisdictions to the UK and indeed to Scotland. That is partly because the UK has one of the most fluid labour markets in the world, as evidenced to some extent by the huge increase in employment over the past few years. A lot of the countries from which one might draw evidence do not have that level of fluidity, and that is very important in relation to income taxation.

**Alan Barr:** I can offer only anecdotal professional evidence that what people do in response to tax rates is, I think, surprisingly limited at the edges. If a tax rate is regarded as penal, they will take action if it is possible to avoid it. A differential of 1p in the income tax rate might have very little effect, whereas a differential of 5p or 10p—again, ironically, disproportionately very few people would be affected by that—is much more likely to have that kind of effect.

My evidence would come from capital gains tax, where people who end up paying a rate of 10 per cent because of rules allowing them to do so are much more willing to say, "We're not going to change our lives. We're not going to move abroad for the necessary period in order to make that disposal." They will not uproot themselves at that kind of level, whereas, if the tax was higher, they would do—and have done—exactly that.

11:15

**Yvonne Evans:** I agree with those comments.

**Murdo Fraser:** Alan Barr talked about the potential for a much more radical departure in tax policy in Scotland compared to the rest of the UK. In reality, how much freedom of operation would any Scottish Government have, given the issue that we have just talked about?

**Alan Barr:** That assumes that the taxation is always tied to the person rather than to other things, such as consumption, land and things that are less easy to uproot. The person is only one connecting factor. It is the most important, but there are other connecting factors, such as location of business enterprises or companies. Some of them are silly, in a way, such as the nameplate effect on low taxes. With others, though, you could make a much stronger connecting factor than the person, if you wanted to do that radically. I just say "could"; I am not saying "should".

**The Convener:** We are covering some quite interesting areas here, but the purpose of the session is to discuss the principles and the high-level issues. Let us try to get back into that if we can.

**Ash Denham:** A number of the submissions mentioned the concept of simplicity. The Royal Society of Edinburgh's submission said that the UK tax code is one of the most complex in the world, and Alan Barr has just referred to that, too. I believe that the UK tax system runs to thousands and thousands of pages and, unfortunately, is riddled with loopholes, which allow people to use the tax system to benefit themselves. I do not think that anybody would seek to replicate that in Scotland, but that is the context in which we are situated.

We recently took evidence from Revenue Scotland, which has just had its first year of operation. Many people who gave evidence on that said that they felt that the system is quite simple and easy to use and that there are good lines of communication. When you talk about simplicity, do you mean the tax code itself or the operational side? Will you explain a bit further?

**Yvonne Evans:** All of those things are important for simplicity. It is not just about making the tax code shorter, although that can be helpful. The way that the legislation is written can also be helpful in reducing the need to change the legislation to close off loopholes. Alan Barr's submission has quite a bit on how to frame legislation in a way that almost future proofs it and prevents it from becoming even longer further down the line.

When we talk about simplicity, we also mean administration. That is very important. Efficiency comes into it, too. That is the ideal. Should taxpayers have to go to a tax lawyer or an accountant to understand tax? That is a big issue in Scotland. Taxpayers just do not understand tax, and something that I am quite evangelical about is that it should be more transparent and readily accessible to them.

**Alan Barr:** Let me give you an example. Revenue Scotland is absolutely right. Sticking to LBTT, for the vast majority of transactions, the system has worked well and is tolerably simple. We then had the introduction of the additional dwelling supplement, which is now creating a range of uncertainties. There are things that people—including, I suspect, the people who enacted the legislation—do not realise that it catches and that it should not catch. Therefore, people will do things to stop it catching those things.

That is a classic example. You start with a tax that taxes the purchase of a home—I am talking only about the residential side. That is straightforward, simple and extremely hard to avoid, so it ticks all the boxes. You then put a layer on top and it becomes complex and more difficult to deal with. We have absolute evidence of that with the additional dwelling supplement now, even in our comparatively baby tax system.

The other side of that basic notion of purchasing property and paying tax is when we move to more complex transactions that involve multiple or lease transactions or that kind of thing in the commercial world. As we discussed earlier, those tend to be the ones that can, or should, produce large amounts of tax, which is where the complexity comes in.

There are almost two distinct levels. The basic is fine and can be kept simple. It is when it gets more complex that you create problems, and the complexity sometimes comes from policy decisions. That is what has led to the situation in which, if I had brought the entire UK tax code, you would not be able to see me if it was arrayed in front of you—it is seven fat volumes of very closely printed pages.

**Professor Bell:** Alan Barr gives an example of where the tax base has been extended to an extent. Our submission argues for wide tax bases that are easily understood, where tax rates can be kept lower and are therefore less distorting in terms of behaviour.

An example in the Mirrlees review concerns confectionery and where to draw the line, as far as confectionery is concerned, as to what does and does not attract VAT. I recall that the eye decoration of a figure made in chocolate had something to do with the definition of whether or not it attracted VAT. That is the kind of area where, eventually, people end up going to law, because commercial interests are involved. Dare I say it, with two lawyers beside me, but the whole thing then becomes slow moving and liable to—well, it requires clarity in the legislation, which is a point that has already been made.

**The Convener:** You almost got out of that, David. [*Laughter*.]

**Alan Barr:** You missed out expensive, as well. Maybe you did not wish to go there.

**Ash Denham:** I see a conflict there, though. We are situated in an extremely complex system, so if we bring in a replacement tax or a different tax, we are already adding to the complexity, even if the new tax is simple and easy to use. There is a tension there, is there not?

**Alan Barr:** There is absolutely a tension there, but sometimes the complexity comes from the policy. Again, I will give a UK example that was well covered in the press, which relates to film investment and film partnerships. We have all seen the tales of people—usually celebrities—investing in that and getting caught out by it. That started from an understandable drive to encourage actual investment in actual UK films. However, people—my profession is on the line in relation to this—saw that they could exploit it differently because of the lack of simplicity and were able to construct things that were no longer in line with the simple policy. That led to people investing who were not really investing completely in the films, which was the original, laudable intention. Therefore, it is a question of where the policy starts from. Is it simply to raise money or is to do other things? Those are very different policy aims.

**Yvonne Evans:** I am sure that a lot of the exemptions and reliefs in the system—there are over 1,000—were well meaning at the time. It has just become so clunky, with so many of them. Of course, once we have put in place a relief, an exemption or an extension to something, it is politically very hard to claw that back.

**The Convener:** Ivan McKee has a supplementary question before I come to James Kelly.

**Ivan McKee:** One of the benefits of talking about a subject like this is that it gives us a bit of space out of the day to day to look at the bigger picture, if you like. I suppose that the whole concept of principle is that it withstands the test of time. We were talking about Adam Smith's principles and they have obviously been around for a wee while. If we look over the medium term, we have a moving feast in relation to what is devolved and what is not. That has changed at least twice in the last three or four years and I have no doubt that it will continue to change. That is even before we start talking about the constitutional question.

I would like to leave all of that to one side and go back to the principles. Do you think that the four principles are the right ones? Are there any that should not be there? Are there some that should be there that are not?

As a starter for 10, we have talked about simplicity, which has a huge bearing on at least three: certainty, convenience and efficiency are all impacted by simplicity. The other one that I would like to throw on the table for your thoughts is behavioural change. We often talk about that in a negative sense when we talk about how are people going to be mobile, and so on. Clearly, it is positive to use behavioural change for consumption taxes, for things that would otherwise cost the health service, to drive low carbon behaviour or capital investment, or to encourage people to employ others. The tax system can be used to drive a whole bunch of positive behaviours.

What are your reflections on whether the principles are the right ones?

**Professor Bell:** There is certainly a case to be made for taxes that tax bads rather than goods. There is a question about whether we all agree about what the bads are and whether the state should be trying to influence our behaviour or what we consume or do not consume. I am not saying that I am on any particular side, but the argument has to be made.

The UK Government has taken fairly strong action on taxing the use of carbon, although it might have rolled back on that a bit recently. In general, I do not have a problem, although there has to be clear consensus around the tax, which would require consultation and transparency and involve many stakeholders in the design of the tax policy rather than just a small number of people in the Treasury or finance ministry.

The general principle is acceptable; inevitably there will be a push-back from whatever commercial interests might be harmed. It might also add to innovation. You might force airlines to adopt more fuel efficient planes or, as we have seen today, tobacco companies to adopt less toxic cigarettes. There might be a behavioural response as a result of taxing so-called bads, which is perhaps a good thing.

**Alan Barr:** I do not think that behavioural effects come in to the principles as proposed. Whether driving good behaviour or stopping bad behaviour should be another principle is something to argue about. It would be additional.

To answer your original question on whether the principles are reasonable, I think that they are. They might be limited and affected by other things, but proportionality, certainty, convenience and efficiency, which are pretty wide words, are good principles.

Behavioural effects do not interact with those particularly well. If you want behavioural effects—stop doing bad, start doing good—that would have to be another principle, and large numbers might differ on what are the goods and what are the bads, and what effective ways of stopping or encouraging them fall within the other principles. I do not think that behavioural effects fit very well into a principled notion of taxation.

We should have such principles, and those are as good as any. Their long life and quotation over hundreds of years indicate that they caught something well. They are not complete, as Mr McKee has just demonstrated, but they are a good start.

11:30

**Ivan McKee:** Mr Barr, is there anything that you would add?

**Alan Barr:** I am not sure that I would, because that gets away from one of the principles and the terms of simplicity and certainty. Four is enough. Could we get to three?

**Ivan McKee:** Simplicity is not one of them—that is the point.

**Alan Barr:** Yes, but there is no question that simplicity flows through quite a lot of them.

**Yvonne Evans:** The Law Society does not have a particular view on taxing bads. One criticism is that it can be quite regressive, particularly when taxing things such as sugary drinks. That can be quite a regressive policy.

On the principles generally, as Alan Barr says, if you define them widely, particularly the ability to pay, and if you consider that in the round, they cover what you would want in an ideal tax system.

**James Kelly:** In your submissions you have emphasised the themes of certainty and efficiency in the tax system. There has bee a lot of commentary today among the press and in the committee about our new income tax powers. How does the system of allocation of income tax revenues to the Scottish budget fit with the principles, bearing in mind that, initially, it is based on forecast numbers? They feed into the block grant adjustment, and it is 18 months before we get the actual figures. Then, it is into the next financial year when the reconciliation is completed and the numbers are actually allocated. There is a time lag. There is much hype about the new powers today, but there will be a time lag of at least two years between the raising of tax revenues and the allocation of the precise figures to the Scottish budget. How does that fit with those principles of efficiency and certainty?

**Professor Bell:** Those principles are based on the perspective of society as a whole. The issue that you are raising is to do with the Government’s budget process and how it is made more difficult as a result of those time lags, which are inevitable, given the structure of income tax, which is the main power that is being devolved.

There is a question about whether forecasting is accurate. Recently, we have seen that the OBR has been very optimistic about income tax revenues in particular. Therefore, my feeling is that the Scottish Fiscal Commission will have to consider carefully whether similarly optimistic forecasts for Scotland would make sense in the future.

There are borrowing powers to deal with the issue of forecasts that go somewhat awry—and it is possible for them to go awry in either direction, of course. Part of the implication of getting tax powers is that you have to take on additional risk. Things could go better or worse, but we have to accept that, with our new tax powers, the Scottish Government's budget must face more risk than it has done in the past.

**Professor Bell:** In direct answer to your question, I do not think that the process that you have described fits with the principles at all, but nor can it be expected to. The principles are to do with the relationship between the taxpayer and the tax-raising authority, whatever that authority is. The process of allocation comes after that stage has been reached. The goose has been plucked. What are you going to do with the feathers? It is a matter of extending the analogy between the various pluckers and that is not something that Adam Smith's principles can properly address. Whether the process should be simpler and swifter is, of course, a matter of great concern and importance, and it probably should be, but if it cannot be, it cannot be. I do not know whether it can be or not.

**James Kelly:** I will press David Bell a wee bit further. It is not just a question of the numbers that end up in the budget. It is pounds and pence and it affects peoples lives. We can take it down to the level of a council having to decide on a budget that might impact on jobs and services. I accept that it is a complicated process—it is not straightforward. How could the process be speeded up to allow accurate figures to be allocated to the budget more quickly?

**Professor Bell:** The issue here is to do with tax receipts and HMRC, and it is partly to do with people who submit tax returns after the year end and might not actually pay until 12 months after the year end, effectively. That inevitably introduces a delay before the full accounts can be drawn up. Whether that process can be speeded up I do not know, but HMRC probably could not do it just for Scotland. It would have to be a change affecting the UK as a whole, and I suspect that many interest groups would like the process to be as long as possible—principally those that may have to pay up.

Within the current constraints under which HMRC is operating, there does not seem to be an obvious way to speed up the process. There might be ways to introduce more evidence as the period progresses. For example, could HMRC make all the PAYE returns, or their value, available to the Scottish Government so that it would at least have that part of income tax information available to it? It could do that almost immediately, I think.

I am not sure how it can be done, but there may be tweaks that might improve the system. A borrowing facility has been put out there, and it is meant to cover errors that could ultimately be derived from the forecasts.

**James Kelly:** I understand what you are saying about HMRC. As I understand it, once it completes its stage of the process, a reconciliation takes place around the 18-month mark. Is there value in considering how that could be carried out quickly in order for the allocations to take place in that financial year, instead of waiting until the next financial year—say, by means of the autumn budget revision?

**Professor Bell:** There might be. There might be ways of collecting survey evidence on people's income tax payments. There are almost in-year calculations that could be done. We referred to problems concerning survey evidence in relation to VAT. There might be a way of collecting survey evidence in relation to income tax and VAT.

**Alan Barr:** HMRC has an ambitious—some say too ambitious—programme called "making tax digital". It is directed at those uncertainties and the delayed payment of tax to some significant extent. It will take a while to bed in. As I say, quite a lot of people think that HMRC was a little bit ambitious in demanding that information up front. To the extent that the programme comes into effect, it will have the effect of knowledge being conveyed and perhaps payment being made much more quickly than would be the case with the kind of delay that David Bell was talking about.

Once that programme has bedded in, the information at least should be available from that source. That might then have a knock-on effect—or knock-back effect, if I can call it that—on timescales because of the necessity to wait for the year end, and a time after the year end, because the information will be available earlier.

**The Convener:** We have about 20 minutes left for members to ask questions.

**Willie Coffey:** I hope to complicate things even more by talking about corporation tax, which Professor Bell's submission mentioned. As you know, the UK was—and may still be—planning to give Northern Ireland a reduced corporation tax rate. Then Brexit happened and the UK suggested that it might lower the UK rate, which must have delighted our friends in Northern Ireland. Is there a case for a variable corporation tax system in the UK, so that Scotland is not at a differential disadvantage to Northern Ireland if Northern Ireland gets a reduced corporation tax rate?

**Professor Bell:** We have mentioned the possibility of people doing things for tax motives, which we try to avoid if possible, because it moves economic activity from where it may be most efficiently located to somewhere else. The Republic of Ireland has had a significant advantage economically in recent decades because it has managed to get people to move there for tax motives, which has left the UK in a somewhat difficult position. If the UK reduces its rate to 15 per cent against Ireland's 12 per cent, the band between the two will become fairly narrow. Whether it will become sufficiently narrow to make moving location not worth while—there are costs to moving—remains to be seen.

I suspect that most countries think that corporation tax is not ideal to drop down to the sub-national level, particularly for the reason that I have given, although that happens in the States and elsewhere. I am not sure where Scotland could advantageously locate itself in the space between 12 and 15 per cent.

**Willie Coffey:** I think that the UK has said that it will not go below 17 per cent, which would be quite a differential advantage for Northern Ireland, particularly with Brexit happening. Scotland would be at a further disadvantage to Northern Ireland if Northern Ireland had something like a 12.5 per cent rate, comparable to that in the Republic of Ireland, and we were stuck at 17 per cent.

**Professor Bell:** We have lived with such a disadvantage for some time. While there is some evidence that companies are willing to move to Ireland, I am not sure whether the evidence suggests that Scotland would be similarly affected if it managed to have a similar rate to Northern Ireland. It is possible that that could happen.

**Alan Barr:** Corporation tax is a difficult issue, because a company's location is not necessarily the end of the story about the rate of corporation tax that is paid—hence the huge press coverage of Google, Facebook and other entities whose economic activity happens in different places from where the company is resident in any legal sense. Without an extension of powers to cover that, exactly what would be taxed in Scotland would, ironically, be open to the same kind of—what is perceived as—abuse, when profits are directed to a place where the rate might be lower, if that is possible to do.

Defining corporation tax by the residence of the corporation is only part of the story, and it may be the smaller part of the story if the differential between rates is greater.

11:45

**Willie Coffey:** Northern Ireland thinks that it will benefit by—

**The Convener:** Sorry—we have done quite a bit on that. Yvonne Evans wants to come in.

**Yvonne Evans:** The Law Society does not tend to comment on particular rates, but we generally agree with the points that have been made. On tax competition, you do not want to trigger a race to the bottom because then everyone loses—that is one point to consider.

**The Convener:** On you go, Willie.

**Willie Coffey:** From what I have read, it seems that Northern Ireland thinks that it will benefit by £4 billion a year and 32,000 jobs if it reduces the corporation tax rate to help it to compete with the Republic of Ireland. Is there no advantage for Scotland in having a similar model? Otherwise, the reverse effect could happen, as we would be in direct competition with Northern Ireland.

**Professor Bell:** I am not sure where those numbers come from. As has been said, economic activity is not necessarily associated with the location of the payment of corporation tax. I am not sure whether, at present, those figures can be treated as a credible set of statistics.

**Patrick Harvie:** On another occasion, there will be time to challenge the assumption that ever-lower corporation tax is of benefit, given that decades of continual cuts to corporation tax have driven the level of inequality that we see in society. Sadly, that will not be discussed today.

On the principle of proportionality, I will ask about one comment in the RSE paper. The Scottish Government uses the phrase

"proportionality to the ability to pay",

but the RSE's submission—along with submissions from others, including the Poverty Alliance—uses the term "distributional fairness" instead. I see what the intention is, but I wonder whether the use of the word "fairness" is open to criticism for not being sufficiently specific, given that quite a lot of very wealthy people think that it is fair for them to dodge tax through every loophole that they can use to do so.

**Professor Bell:** We were a bit dubious about using the term "proportionality" because the concern was that it might be taken to imply a strictly proportional tax, which is not a progressive tax. In terms of equity, the ability to pay is a concept that is quite difficult to define, partly because most people take it to relate directly to income. That definition ignores wealth, which is an important component that people may have that affects their ability to access goods and services.

**Patrick Harvie:** Increasingly so.

**Professor Bell:** There is then the question about how we assess equity. The Scottish budget includes an equality impact assessment, for example. We think about equalities mostly in terms of the effect on individuals or households, but there is a case for looking—as the equality impact assessment does—at certain groups by gender or age, although the Scottish Government has not in the past done all that much on the latter aspect.

We were a little concerned about a strict definition of the term "proportionality" and we wanted to think about distributional equity in the round.

**Patrick Harvie:** Would one way of framing the principle be that the tax system should seek to reduce or limit wealth and income inequality?

**Professor Bell:** That could be one objective—a distributional motive for the tax system is certainly there and it could be argued that it is a key purpose of the tax system. However, there are other objectives that tax systems typically try to invoke, one of which is stabilisation, which means using the tax system to keep the economy on an even keel. The tax system might also be used to support growth.

**Patrick Harvie:** Some of that applies to the other principles; I was just asking about a way of framing the question about proportionality.

**The Convener:** Yvonne Evans mentioned horizontal equity, which I had not heard of before. Will you tell us more about what lies behind that? It is slightly different from other things that we have heard about.

**Yvonne Evans:** Let us say that we have two taxpayers who have similar incomes, but one is self-employed and the other is employed. Under perfect horizontal equity, those people would expect to be taxed in exactly the same way, but that is very much not the reality in our tax system when we look at how those two taxpayers would be treated for income tax and national insurance. We also have vertical equity, which is to do with progressivity in the system.

**Patrick Harvie:** Ivan McKee raised the issue of other policy objectives, such as behavioural change, being driven by taxation systems, which Alan Barr discussed. As I understand it, the efficiency principle relates to the idea that the system should minimise negative effects on welfare and economic efficiency. Rather than adding a principle, which I think was Alan Barr's concern, surely the way to capture that is to seek to maximise social, environmental and economic benefits from the operation of the tax system. Would that capture what is being sought without adding complexity?

**Alan Barr:** That sounds to me more like a policy than a principle, in that the tax system may be a lever to do those things, but whether we want to do them in a principled way is determined by policy. What you said about wealth inequality struck me more as policy driven than principle driven. The policy may well be to reduce wealth inequality—that is a perfectly reasonable policy—but the principle on which that should be done is much more likely to involve actual proportionality, for example, as a principle of doing so rather than an absolute—

**Patrick Harvie:** Surely if the principle is proportionality to the ability to pay, that hangs on a policy assumption that that is a good thing.

**Alan Barr:** It does, but that does not necessarily reduce wealth inequality. The fact that the richer, or those with the greater income, can pay a great deal more and should, under that principle, pay a great deal more, does not mean that that will necessarily reduce inequality in any absolute sense.

**Patrick Harvie:** David Bell's paper gives an example of other objectives, too, and mentions the carrier bag charge. Few people would disagree with the claim that the approach of successive Governments to the taxation of cigarettes has been socially beneficial and that it has been intended to achieve a change in behaviour and not necessarily an increase in revenue. There seems to be a question about the principle of the operation of the tax system that is implicit here rather than explicit, and the question is simply whether we should make it explicit.

The issue relates to generality in the tax system rather than raising a tax specifically from people who gain a benefit from a particular public service. Some people make the case for such hypothecation, but others say that it is important to the cohesive nature of society that tax tends to be general rather than specific. Is it important to get those principles stated rather than having them hanging around in an unstated way?

**Professor Bell:** That is a good point. In considering the behavioural effects of the taxes that one might apply, it is important to keep bearing in mind acceptability.

Hypothecation is an interesting issue with regard to the political acceptability of changes that can be made to the tax system. Increasingly, politicians think that such changes will be acceptable only if we hypothecate for a specific public spending objective, whatever extra revenue is raised.

The UK Treasury has always tended to avoid hypothecation and has argued that it ties the Treasury's hands. There are serious dangers in having a large chunk of the tax system specifically hypothecated for particular purposes, because—who knows?—public priorities might change through time and people might wish to do other things.

In the short run, hypothecation probably helps with the acceptability of changes to taxation. For example, we can see clearly that the additional revenue from the increase for some council tax bands will be hypothecated to the education budget. That raises all kinds of questions that I do not have time to go into, but it is clear that such hypothecation carries a political risk as well as a potential gain.

**Patrick Harvie:** I acknowledge that.

**The Convener:** Does Alan Barr want to respond?

**Alan Barr:** We sometimes understate the pure revenue-raising effects of some behaviourally driven taxes. If they were entirely behaviourally driven, they would be set at a prohibitive level and aimed at stopping people doing things or restricting those things to a very low level. However, the revenue raising of the sin taxes, if I can call them that—those on fuel, gambling and that kind of thing—is extremely important in a mixed tax system. That might be a slightly cynical suggestion, but that revenue raising is an important part of what the taxes do. If the taxes were truly behavioural because something should be banned, it should be banned.

**The Convener:** Patrick Harvie can come back in quickly; I must get Dean Lockhart in.

**Patrick Harvie:** I have one final question—I know that we are tight for time. It is on the principle of transparency. It seems to me that there should be transparency around not just how the system works but what it is for. The only communication that I, as a taxpayer, have had from any level of government about what my taxes are used for is a flyer from the council that comes with my annual council tax bill; it usually has a picture of a bin being emptied. If we want people to have confidence in the new Scottish approach to taxation, should not the Scottish Government spend some time thinking about how it communicates to individual taxpayers what it is trying to achieve through taxation and, more particularly, why it is doing that—for example, by showing how taxation relates to the challenges that we face collectively as a society?

**Professor Bell:** I tend to agree with that point. I alluded earlier to the way that the UK has done things for the last goodness-knows-how-long, which I do not think is a very good way of defining or setting our tax system. Some time ago, Neil Warren from the University of New South Wales gave evidence to the committee, and I was particularly struck by his reporting of the system that is used in New Zealand, which seems to be much more encompassing. Changing the tax system there involves various stages: strategic, tactical and operational. At the strategic level, large numbers of stakeholders are involved in the process so that they can better understand not only the gains but the potential costs that are associated with significant changes to the system.

**Alan Barr:** I agree, as long as one does not get too hung up on the tax system or devote very large resources to operating it, and it does not get used as a political football. If it goes slightly wrong, that should not be the end of the world. That kind of transparency is extremely important and will be helpful in encouraging people to accept the taxes. In the end, a tax system must be acceptable to those who pay the taxes.

12:00

**Yvonne Evans:** I will be boring—I agree with Alan Barr and David Bell. Every year, HMRC sends out a statement, which contains a pie chart, that tells the taxpayer broadly where their tax has been spent. That has been criticised because it covers only income tax and national insurance and does not really explain where all the tax is going. There has been some attempt in that respect, but we would welcome more transparency.

**Dean Lockhart:** My question relates more to technical aspects than to principles of taxation—it is on the correlation between GDP growth and tax take by the Scottish Government. Professor Bell, at paragraph 22 of your submission you state:

> "The make-up of the tax base for Income Tax in Scotland is noticeably different from that of"

the rest of the UK. You go on to note that

> "In Scotland just 0.7% of taxpayers ... pay the Additional Rate of Income Tax compared to 1.1% in the UK as a whole."

Does that mean that the same level of GDP growth in Scotland might result in lower tax take in Scotland in comparison with the rest of the UK? The reason why I ask is that, under the new fiscal framework, relative tax take in Scotland versus the rest of the UK will, in part, determine the level of public spending.

**Professor Bell:** That relates to the block grant adjustment and the per capita indexed mechanism. Of itself, the fact that we have a lower proportion of additional-rate taxpayers does not necessarily mean that, with a given rate of GDP growth, income tax revenues in Scotland will grow less quickly. It all depends on where that growth is coming from. I am a bit concerned about income tax revenues not at that end of the income spectrum but at the lower end. A lot of the increase in employment since the great recession has been relatively low waged—I am talking about the kind of people who are employed at levels of income that are below the income tax threshold. We could see a pretty significant increase in Scottish GDP—and a large growth in employment—without necessarily seeing any significant increase in income tax revenues. That is considerably important. It is difficult to predict based on the distribution of taxpayers at different levels, but the additional-rate taxpayers are very important and Scotland could not afford to lose a significant number of them; there is no question but that that is the case. Recently, I ran a survey of personal incomes to look at the most up-to-date data. The top 1 per cent of taxpayers, going beyond additional-rate taxpayers in Scotland, contribute 23 per cent of the total income tax revenues. That group is critical to the overall tax take, and the issues around how those taxpayers account for their income become very important.

**Alan Barr:** This is not my field, but I agree: I do not think that there is a direct correlation. Those two elements—the number or proportion of additional-rate taxpayers and GDP growth—are not likely to fit particularly well together as parallel indicators.

**Yvonne Evans:** I agree with that.

**The Convener:** I thank the witnesses very much for coming along today to begin our discussion of tax principles. This is our first session on that area, which is a bit more complicated than I had anticipated at the beginning of the process. We will be having important discussions as the months go on. At the start of the meeting, we agreed to take the next agenda items in private, so I close the public part of the meeting.

12:04

*Meeting continued in private until 12:28.*

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