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SCOTLAND BILL COMMITTEE

Tuesday 18 January 2011

Session 3

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SCOTLAND BILL COMMITTEE
2nd Meeting 2011, Session 3

CONVENER

*Ms Wendy Alexander (Paisley North) (Lab)

DEPUTY CONVENER

*Brian Adam (Aberdeen North) (SNP)

COMMITTEE MEMBERS

*Robert Brown (Glasgow) (LD)
*Tricia Marwick (Central Fife) (SNP)
*David McLetchie (Edinburgh Pentlands) (Con)
*Peter Peacock (Highlands and Islands) (Lab)

COMMITTEE SUBSTITUTES

Michael Matheson (Falkirk West) (SNP)

*attended

THE FOLLOWING GAVE EVIDENCE:

Professor Sir Kenneth Calman (Commission on Scottish Devolution)
Professor Gerald Holtham (Cardiff University)
Iain McMillan (Commission on Scottish Devolution)
Professor Anton Muscatelli (University of Glasgow)
Professor Dr Paul Bernd Spahn (Goethe Universität)
Professor François Vaillancourt (Université de Montréal)

CLERK TO THE COMMITTEE

Stephen Imrie

LOCATION

Committee Room 1

Scottish Parliament

Scotland Bill Committee

Tuesday 18 January 2011

[The Convener *opened the meeting at 14:17*]

Decision on Taking Business in Private

The Convener (Ms Wendy Alexander): Good afternoon and welcome to the second meeting in 2011 of the Scotland Bill Committee. As usual, I invite members, witnesses and guests to ensure that their mobile phones, pagers and any other electronic devices are turned off before we start. We have received no apologies from members and no additional MSPs will be joining us.

The first item on our agenda is to consider whether to take item 3, which is our work programme, in private. Is that agreed?

Members *indicated agreement.*

The Convener: Thank you.

Scotland Bill

14:17

The Convener: We move on to the meat of today's business, which is to continue to take evidence as part of our scrutiny of the Scotland Bill and the relevant legislative consent memoranda.

Today's meeting is a round-table session involving witnesses from the international arena. Your presence with us today is an indication of the entire committee's determination to scrutinise the bill, and the improvements that have been suggested to it, thoroughly and fully. I am pleased that we have with us four professors—Professor François Vaillancourt of the University of Montreal; Professor Gerald Holtham, visiting professor at Cardiff University; Professor Paul Bernd Spahn from the Goethe Universität; and Professor Anton Muscatelli, who is the principal of the University of Glasgow.

For the benefit of people who do not have the papers in front of them, I will mention the areas that we intend to cover today. First, we will invite general views on the bill. We will move on to the income tax provisions and the other taxes that have been suggested for inclusion in the bill. We will then move on to the grant reduction mechanism, short-term borrowing, the transitional mechanism, and finally capital borrowing. We are tight for time to complete all that and then move on to our next panel, so we are thinking of devoting roughly 15 minutes to each of those topics.

I intend momentarily to move straight to questions, but given that we have a round-table format, I think it will be helpful if I invite everyone to briefly introduce themselves. I will start with Brian Adam.

Brian Adam (Aberdeen North) (SNP): I am the MSP for Aberdeen North, deputy convener of the committee, and a member of the Scottish National Party.

Professor Dr Paul Bernd Spahn (Goethe Universität): I am emeritus professor at the University of Frankfurt in Germany and I have been advising a number of international organisations all my life, mainly on taxation and decentralisation issues.

Robert Brown (Glasgow) (LD): I am the MSP for the Liberal Democrats for Glasgow. It is relevant to the committee's work to mention that I was vice-chair of the Steel commission, which was the Liberal Democrat party's contribution to moving towards federalism.

Professor Anton Muscatelli (University of Glasgow): I am the principal of the University of Glasgow. Previously, I was a professor of economics, and I chaired the independent expert group that gave evidence to the Calman commission.

David McLetchie (Edinburgh Pentlands) (Con): I am the member of the Scottish Parliament for the Edinburgh Pentlands constituency, and a member of the Scottish Conservative party.

Professor Gerald Holtham (Cardiff University): I am a former director of the Institute for Public Policy Research. I chaired the independent commission that was set up by the Welsh Assembly Government into financing the devolved authority in Wales. We made an effort to do so in a way that would be consistent with the general scheme of devolution in the United Kingdom.

Tricia Marwick (Central Fife) (SNP): I am the MSP for the Central Fife constituency, and I am a member of the Scottish National Party.

Professor François Vaillancourt (Université de Montréal): I am a professor of economics, specialising in public finance, at the Université de Montréal. I have worked for various international bodies, giving advice on decentralisation, and for the federal Government of Canada and the Council of the Federation, which is a body grouping the provincial premiers in Canada.

Peter Peacock (Highlands and Islands) (Lab): I am a Labour MSP for the Highlands and Islands.

The Convener: Those are the formal participants in the round-table discussion. Also at the table are people from the parliamentary research services and various clerks. I make specific mention of the two expert advisers to the committee: Jim Gallagher and Professor Ulph.

I would like to hear our international experts' general views on the Scotland Bill proposals. I invite Professor Vaillancourt to start.

Professor Vaillancourt: I will give you a general view—in five minutes, I can do no more.

A fundamental idea behind devolution and decentralisation is to improve the delivery of public services in a given area by giving power to people who are elected by the residents of that area. That works well if you have spending responsibility combined with some revenue responsibility. In general, you will not be able to collect all the required revenue—there will be a spillover of taxation, with the appropriate level of taxes set by level of government. Fundamentally, if you are spending only other people's money, you will probably not have as good governance performance as you would have if you had some responsibility for going to the electorate and saying, "Look, I want to take this money from your pocket and spend it in a fashion that I have explained to you. Do you agree or not?"

The Scotland Bill and the changes that you are discussing right now go in that direction. They will strengthen devolution in Scotland. In the middle term—the next 10 to 15 years—they should improve governance by creating a stronger link between spending and revenue. In general, therefore, the Scotland Bill is a good thing, in principle.

I believe that the instrument that has been chosen, personal income tax, is the best one for the purpose. Corporate income tax is difficult to administer at a subnational level, because of tax shifting between various jurisdictions. Value added tax is a feasible option—it is administered at the subnational level in parts of Canada, for example—but it is also difficult to administer in such a way. Personal income tax allows people to see a relationship between what they pay and what they get, and it is linked to the responsibilities of the Scottish Parliament, such as education, social services, health, long-term care and so forth. It is, therefore, an appropriate tool.

The degree of choice that is proposed—the 10p rate—could be argued to be an acceptable first step. However, if you look at the various changes that are happening throughout the world—in Spain, Canada and so on—it is probably a minimum. We can discuss that later.

On the issue of the transition, there are certain technical issues that could be improved.

On the issue of borrowing, the great mystery to this Canadian was why a limit of £2.2 billion had been chosen. Clearly, one needs principle-based guidelines with regard to the issue of capital markets. In the papers that I have seen, I have not found the principle that led to the choice of that number. That is something that needs to be revised. A figure should be found that is based on gross domestic product, the capacity to pay, revenue or whatever you think appropriate.

The Convener: Thank you. I am keen that everyone has an opportunity to say an initial word on the record.

Professor Spahn: I will start with something that I read in the paper this morning—there is no firm relationship between fiscal autonomy and growth. It would be risky to make that case. On the other hand, I agree with what François Vaillancourt said about the need to have fiscal autonomy on top of spending autonomy in order to make a Parliament fully accountable to its electorate. It would also set the right incentives for making the region grow stronger than it would without that fiscal responsibility. However, there is no automatic relationship between the two; it all depends on the quality of your policy.

Having said that, and after looking at the proposals in more detail, I note that there are all sorts of tax sharing world wide, including VAT and corporate taxes. It is right to start with personal income tax. You would share the base with the national Government, which is a good thing to do, taking into account that you want to be part of a union and not a separate entity. When we go into more detail on income tax, we might have to discuss whether a flat tax is the appropriate way to go. You might have noticed that the Holtham commission, of which I was a member, opted for a progressive tax, which has certain attractions, to me at least. We have to link the taxation powers to the grant, but that will be for later consideration.

Generally, I appreciate the work that has been done by the Calman commission, which has now found its form in the Scotland Bill.

Professor Holtham: I have been pre-empted to some extent. The broad structure of the bill is coherent and I have no quarrel with it in principle. The more autonomy that you have, the more freedom of action you have, but that tends to mean that you lose some of the insurance characteristics of being in a larger fiscal entity. It is a matter for the Scottish people how far they want to trade off freedom of action against a safety net or risk-sharing structure that exists in a larger fiscal union.

As far as the structure of the bill is concerned, I agree with the other witnesses that income tax is the obvious place to start. There are only three or four large taxes, of which income tax is one. There are fewer difficulties with income tax than with any of the others. Certain areas of the bill have drawbacks, but I believe that in each case they are susceptible to a technical fix—improvements could be made that would solve the problems to which people have pointed. There have been some genuine and fair criticisms that can be resolved without throwing the whole thing out. The basic structure is okay, but there are areas in which the bill could be fine tuned.

Professor Muscatelli: I am happy with the general structure of the bill because it fits well with the proposals and recommendations that my expert group made to the commission. As Gerry Holtham pointed out, where you sit on the spectrum between greater risk and greater accountability is a political issue and not an economic one. We pointed that out to the commission from the start.

The commission chose a point that strengthens accountability and balanced it against risk by introducing a certain amount of revenue risk for the Parliament. However, the bill does not adopt some of the more volatile taxes, such as corporation and other taxes, that would inject more risk into the Parliament's revenues. Income tax has less impact in terms of tax spillover or tax competition, so it is the obvious place to start. Not surprisingly, that is where a lot of other devolved and federal Governments choose to place themselves when it comes to sharing taxation.

14:30

The bill could be improved in a number of areas. The convener referred to a number of technical issues on which the expert group did not make active recommendations; I dare say that we will discuss those. A 10p tax that is fixed across the range is a simple device that in many respects makes the whole tax structure a bit simpler to handle than allowing full action across the full range of thresholds and tax rates. That is one reason why we made the proposal. I am happy to discuss the technical issues that relate to some other items.

The Convener: We should move directly to the structure of the income tax powers, which, as people will be aware, has been subject to extensive criticism. I would like to explore some of that criticism. There is concern that we will not have access to the fruits of growth because we will get a smaller proportion of revenue from the higher tax bands, as they are currently structured, and that the Scottish Parliament may have to raise its income tax rate to offset the decline of income tax as a share of total revenues. It is said that we should also be concerned about the impact of one Government's tax changes on another—the vertical fiscal externalities. I urge people to address directly the issue of how the income tax power should optimally be structured.

Professor Holtham: You raise a mixture of points. In the first place, you cannot entirely eliminate spillovers. If the British Government does things with its tax policy, it will affect the prosperity of France to some extent. France is a big trade partner; if we impoverish ourselves, it will suffer. The search completely to insulate your policy against a neighbour's policy is a mirage or wild goose chase. However, you should structure arrangements to minimise spillovers and to ensure that, as far as is possible, risks are allocated in the right place.

I take it as axiomatic that the Scottish Government will wish to bear the risk that is consequent on its own policies. If it adopts a rate policy that has an effect on the Scottish economy and tax base, it will want to be able to experience that effect and to internalise the consequences—to reap the benefit or, if it does the wrong thing, to pay the price. However, it will not want to bear the consequences of policy changes elsewhere.

The bill as it is currently structured can be criticised on the ground that, if the UK changes personal allowances, the value of the devolved tax will be altered. There are ways around that, but you want to ensure that, as far as is possible, the UK Government takes the consequences of its actions and you take the consequences of your actions. That is absolutely achievable within the current structure.

Brian Adam: Can you highlight the effects of the current proposals on how risk is shared and on accountability?

Professor Holtham: There is an interim arrangement for which there is nothing to be said. It is totally indefensible—I do not know why anyone would even contemplate having it. I would junk it straight away. I can give you chapter and verse on that, if you would like.

The Convener: We will come on to the transitional arrangements.

Professor Holtham: Under the interim arrangement, the Scottish authorities will not reap the benefits of their actions or pay for the consequences of their mistakes. Because, in effect, the deduction from the block grant will be indexed to your tax base, you will be able to do whatever you like to the tax base and be compensated in the block grant. You do not want to do that. The incentives in the arrangement are all wrong. It is also unnecessary. I cannot see what useful purpose it serves if you structure the system properly, especially given the smoothing arrangements for tax revenue that are built into the bill.

If you move to the final arrangement, the Scottish Government will be left with the consequences of its actions. However, the arrangement as currently structured also exposes it to changes of policy by the UK Government. There is a no-detriment clause that provides for the UK Government to fix things, but that could lead to rather messy negotiations.

It is possible to improve on that—we will go into it in detail, but essentially the deduction from the block grant should be whatever it is in the first year, and then indexed not to the block grant itself as a percentage of that grant but to the UK tax base. If the UK Government starts messing with the tax base, it will automatically result in a change in the deduction from your block grant. If it increases personal allowances, for example, which reduces the value of your taxation but by the same token reduces the UK tax base, the deduction will be indexed to that so that it goes down and the block grant goes up. You can automatically set it up so that you are not exposed to UK policy risk.

Brian Adam: Part of your submission, which covers that general area, deals with the issue of deflationary bias. You engaged in at least part of the debate that is going on.

Different views have been expressed to us by the two Governments concerned. The Scottish Government says that there will be an £8 billion black hole if we continue with the arrangement that is proposed in the bill, because if that arrangement, as opposed to the current Barnett formula, had been used between 2000 and 2010, we would have had £8 billion less. The UK Government has given us a different figure, but has not given us the methodology. Have you quantified that? How do you deal with the issue around deflationary bias?

Professor Holtham: I do not have an exact figure, but although it is very probably true that simple Barnett would have given you somewhat more revenue in the past eight years than what is currently proposed, it is absolutely predictable that what is proposed will give you more money than Barnett in the next 10 years. That may be one reason why the Treasury wants to impose this intermediate nonsense on you: to stop that happening.

You are looking at an historical period in which expenditure on health and education—the two devolved areas—grew faster than British Government expenditure in general, and in which we were building up a lot of debt so expenditure grew faster than taxation in general. If you think that that will happen in future you can worry, but it is certain to be the case that taxes will grow faster than expenditure over the next 10 years because we are paying back the debt. That was a very peculiar historical period and I would not advise designing a taxation system just from looking at that experience. We cannot repeat that experience unless we want to go bankrupt.

Brian Adam: But, given that the general direction of taxes throughout the developed world is to move away from income taxes—direct taxes—to indirect taxes, how would the proposals affect us in the end? If general taxation continues to rise, but the share of it that comes from income tax—let alone the individual levels—is smaller, would we end up with a smaller amount of money to spend because we are reliant on a tax that will be proportionately smaller in the overall tax take?

Professor Holtham: There are two separate points. First, I would again be cautious about extrapolating from a particular historical experience. After the second world war the top rate of income tax in the UK was 96 per cent, and we did not have a value added tax. It is pretty clear that in 50 years we have moved from direct tax to indirect tax. Now, the basic rate is at 20p and VAT is at 20 per cent. How much further do you think that tendency will go? I do not think it safe to assume that the trend will continue to move in the same direction. It may be—

Brian Adam: There has been a steady rise in VAT. There was a temporary blip when it went back from 17.5 to 15 per cent, but it is now at 20 per cent.

Professor Holtham: But would you forecast that income tax would be at 10p and VAT would be at 30p in 10 or 20 years' time?

Brian Adam: The base of VAT could be broadened and it could be put on things such as children's clothing and food. Any Government that wants to do so can continue the direction of travel, not necessarily just by using the main lever but by changing the tax base itself.

Professor Holtham: I absolutely accept that. As I have said, you cannot assume that indirect taxes will continue to rise at the expense of direct taxes, although that might happen to some extent. However, I also point out that the Scottish Government's revenue comes from two sources: taxation and a block grant. The block grant is structured around expenditure, which means that if the UK Government continues to switch money from direct to indirect taxes any extra expenditure will—as long as the money is spent—be reflected in the allocation via the Barnett formula. You are pointing not to an absolute squeeze on the total level of Scottish resources but to what is certainly a possibility that over time the grant will grow in importance relative to taxation.

Brian Adam: If a higher proportion of money comes from the block grant instead of taxation, will that not have the same sort of gearing effect that has made it very difficult for local government to make autonomous decisions? After all, to raise an additional 1 per cent of finance, it has to raise council tax by 5 per cent.

Professor Holtham: Yes. Of course, under the bill, only 20 per cent of revenue will come from taxation. If you wish to increase revenue, you can have very exciting-looking percentages of the tax take.

However, we took the view that it would be better to have a constant proportion of each tax bracket—in other words, half would be on the basic rate and half on the higher rates. If the proportion of each tax bracket devolved to Scotland is the same, your revenues will grow at the same rate as overall income tax rates and, if anything, you should expect the share of the Scottish revenue that comes from taxation rather than the grant to go up. After all, the grant is more or less geared to the growth of total revenues and income tax is more elastic than most other taxes. In a given tax structure, income tax grows faster than income while VAT and other things grow at the same rate. If you had a constant share of each tax bracket, you would expect the revenue from the Scottish income tax to grow faster than the money from the Barnett formula and for that share of income to rise.

Professor Spahn: It is true that, at the international level, there was significant pressure particularly on top income tax rates and marginal rates for top income earners have been brought down to manageable levels.

Recently, though, I have noticed a reversal of political attitudes in many countries. People are now very much concerned about growing income disparities and have rediscovered taxation as a means of taxing high income earners and making them contribute to the public purse. I am not sure what will happen in that respect. You are totally right that that was the trend in the past and, as Professor Holtham made clear, it all started with rates that were certainly not sustainable. We have now come down to manageable levels but I doubt whether that trend will continue. Income will undoubtedly grow with GDP and, as long as you have that and a proportional tax on income, I would expect things to grow at least with an elasticity of 1.

Brian Adam: Can you spell out for those of us who are not economists what you mean by "elasticity"?

Professor Spahn: Elasticity is how a tax increases relative to its tax base. The tax base of the personal income tax is a big chunk of GDP—another part is, of course, corporate income, which is not included—and given that personal income is more or less increasing in line with GDP, it can be related to GDP growth.

If we take the two bands together, we find that the Scottish income tax has an elasticity of 1.2. In other words, if your GDP increases by 1 per cent a year, your income tax will grow by 1.2 per cent. Of course, that means that your share will increase. As it stands now, you have opted for a flat rate of 10p, or whatever it will be once you have made a decision, which is of course an elasticity of 1—straight to the base.

14:45

The Holtham commission has opted for a progressive devolved income tax, and there is some rationale for that. If you look at the structure of your expenditure, it is mainly in health, education and so on. Those public functions have increased relatively more than other public functions in the past, and I cannot see any reason why that should not be the case in the future. All the countries that I have visited have seen education spending and health spending grow faster than total public spending. They are devolved, therefore the Scottish Parliament has responsibilities in areas in which there is potential for stronger growth than national growth, especially if there is a certain level of disarmament, which we have seen over the past few decades. That is another reason for asking for a more dynamic tax than a proportion of income, and it could be defended on that ground.

There is another aspect that makes it attractive to control the low rate and high rate of tax. If you have one flat band, raising it also affects the top income earners, and because they are a bit more sensitive to tax variation than are middle income earners, they might decide to leave Scotland and move their residence to England. In a way, that limits the possible scope of your action. If you control both rates, you can increase the lower rate but keep the marginal rate on top at a constant level. If you did that within limits that were agreeable to Westminster, that would be the way to go.

Professor Muscatelli: I agree that there are a number of considerations around progressivity and ensuring that the income tax take does not increase with income.

Another consideration that the expert group had was about maintaining the structure of the UK tax system, which is relatively simple. The Scottish Parliament could be given the power to vary thresholds, to change the nature of the tax base and to vary the tax rate, but that could not be implemented because of the UK's pay-as-you-earn system. It would require moving towards a type of system more like those that are used in continental Europe or other countries with federal structures where everyone has to submit a tax return. A number of complexities are involved in the interface between local and national taxation. The expert group's feeling was that a model that allowed some variation of the tax rate but which was not as sophisticated as varying all the thresholds would perhaps be simpler to implement, at least in the short term, while giving some degree of accountability.

However, I accept what my colleagues have said about avoiding the problem of losing higher earners. At the margin, higher earners are the most mobile of the tax base, so if the Scottish Parliament decided in future to use the 10p discretion and raise taxation by 3p across all tax bands, it would have an impact on the higher end. Those issues need to be considered, and that has been picked up.

The Convener: What are the lessons from Canada?

Professor Vaillancourt: I am in general agreement. Even if it is true that the share of income tax and all taxes will go down in the UK until 2020, that does not vitiate the choice that has been put in front of the committee by the Scotland Bill. Income tax is still the most proper tax to initiate devolution of taxation power in Scotland.

Brian Adam: But there are alternatives. A basket of taxes could be used. The assumption is being made that income tax is the only option. If there were a basket of taxes, the total tax base could be reflected, rather than just the income tax base. That would address the problem of whether there was a differential between direct and indirect taxes.

Professor Vaillancourt: If you are to start something, the one to start with is income tax, in my opinion. That is not to say that you will not do something else 10 years from now, but let us demonstrate to the Scottish people that you can administer or manage one tax properly and then go on to a second one—the one that is most related to current spending. That is the perspective that I would advance.

The issue of mobility is an interesting one. In Canada, for the top combined federal-provincial rate, the difference between the lowest-tax province and the highest-tax province is 10 percentage points: there is a maximum 39 per cent tax rate in Alberta, and it is roughly 49 per cent in Québec and Nova Scotia. We live very well with a 10 per cent difference. We are a slightly larger country, I grant you, and we do not use high-speed trains so much, but there are not droves of people moving between provinces because of that difference. If there is such a thing as a preference for living in Scotland, small 1p or 2p differences should not drive thousands of people away.

The issue is one of tax administration. Is it possible to identify where people really live? In my country, we associate the provision of provincial services, including health insurance, with a person having registered their tax address in a province. If it is completely costless to declare a false address, some people will do that, even if the difference is as low as 1p, so there should be some cost to having a false address.

You asked about three issues, convener. On vertical externality, which is the issue of moving, if people move from Scotland to England to avoid an increased Scottish tax, there is no externality to the UK as such, and the tax base is still national. If there are moves offshore, there is a loss to the UK. There might also be an impact if people are discouraged and do not work as hard, but that is unlikely. Notwithstanding recent work by the Institute for Fiscal Studies, I have some doubts about the degree of elasticity. I can find you various studies that give you various results on that topic.

All the various issues about share of growth and share of income tax should be raised and noted, but I do not think that they fundamentally question the choice to be made. I suggest that the idea could be to give freedom to set tax rates for the various bands. Canada began with a tax on tax—a surtax. If there were two bands—say, 20 per cent and 40 per cent—and the province applied a surtax of 50 per cent, the total rates were 30 per cent and 60 per cent. That meant increases of the same percentage, but increases of 10 and 20 percentage points in taxation respectively. We then moved on to giving the provinces the right to choose their tax rate for each band and the right to choose the bands. I would not go as far as to choose the bands in Scotland right now.

If there is fear of high-income taxpayer mobility—I am not able to judge whether or not that is appropriate, but it is probably exaggerated, from what I have seen in other countries, although I could be wrong—the committee should consider recommending flexibility for each tax rate in each band. That would mean that it would be possible to go, for instance, from 20 to 22 per cent in one band and from 40 to 41 per cent in the next, and not to change the 50 per cent rate, if those were the three rates.

The Convener: Why do you suggest two stages, starting with a fixed sum—the surcharge—and the 10p—

Professor Vaillancourt: I am not suggesting that, but I am saying that such an arrangement would give you flexibility. You would be allowed to modulate which group you targeted. If you believe that Scotland should be a millionaires' paradise, you do not target the rich; if you want to go the other way, that will be the policy choice. Right now, if you go from 10p to 11p—we are obviously discussing tax increases, although tax decreases are of course nicer to sell—everybody goes up by 1p. There is no choice right now—an increase from 10p to 11p would be reflected on everybody. Flexibility is always preferable in tax policy.

The Convener: I am mindful of the time. We should move on from income tax to corporation tax.

Peter Peacock: I was going to try to widen things out, convener.

One criticism of the proposal on income tax relates not to the technicalities that we have discussed hitherto but to its being the wrong tax to devolve if the objective is to stimulate economic growth. As Brian Adam hinted, a wider basket of taxes is required to do that. In his opening remarks, Professor Vaillancourt emphasised that the purpose of devolution is to focus on public services—the services that we deliver and over which we have control. I am interested in that, Professor Vaillancourt, but you did not mention economic growth at all. Professor Spahn said that we should not believe that a focus on either would give rise to economic growth. If you devolve taxes with the objective in part of promoting economic growth, how does income tax figure? Is that a realistic objective given what you have said?

Professor Vaillancourt: I would never recommend doing that.

Professor Spahn: In Germany, we have only a tendency towards broadening the share—I include VAT, corporate income tax and other smaller taxes in that. We do that because we mistrust sharing one single tax; instead, we have structural divergence. I have seen that done in other countries, too. Once you go for value added tax or corporate tax, you need an allocation formula, the basis of which is the number of inhabitants. That takes you back to the Barnett formula. In a way—if you wished it to be so—the Barnett formula could be a tax plus borrowing share mechanism. It would be relatively appropriate to do that, as Barnett links to the functions that are devolved to Scotland. You already have a mix; we are not talking about income tax on its own.

In terms of the extent to which the income tax base deteriorated relative to the VAT base, an automatic correction would be made. That would be discussed once the tax had been linked to the Barnett grant. If the base slid downwards all over the UK, the deduction from the Barnett grant would also slide down. You would be compensated in that way. Implicitly, you would have a tax-sharing scheme plus part of the national borrowing.

The Convener: I think we need a bigger basket.

Professor Holtham: Bernd says that there are more taxes in Germany, but they are just assigned—the devolved authorities do not have the ability to alter the tax rates. There are difficulties with VAT, for example, in that European legislation places a restriction on having different VAT rates in a given jurisdiction, but also because variations can lead to smuggling and huge trade distortions. It is all too easy to buy kit somewhere and move it somewhere else. There are big problems in that regard. If you want to have the power to alter rates, you really want to look for taxes where the base is fairly immobile. As I understand it, that is very much what you want to do. Your ability to alter VAT rates is negligible—forget it—whereas your ability to alter income tax rates, particularly basic rates, is fairly substantial.

We have suggested a scheme for some devolution of corporation tax, but that would not be entirely straightforward. I do not know the numbers for Scotland, but those for Wales are illustrative. In Wales, corporation tax raises about £1 billion. If Wales were to cut corporation tax, by how much would it cut it? It would need to cut the rate by 25 per cent, otherwise it would not affect anybody, but that would be a £250 million loss from its budget, which is quite substantial. Also, corporation tax is very cyclical, more so than income tax. There need only be a recession and that £1 billion could easily drop by a third or even a half, in which case Wales could be looking at a £300 million or £400 million hole in the budget. You can double the numbers for Scotland. That may be one reason why Anton Muscatelli's expert group did not jump on corporation tax, given the difficulties in managing the budget volatility that it would introduce.

15:00

The Convener: But you suggested discussions on the matter in your report. We will come to how the Canadians manage it in a minute.

Professor Holtham: Yes. We produced a scheme that we said that the devolved authorities should have the ability to opt for, but we did not say that they should opt for it—that is a political decision. It is a good example of the general trade-off that you face. If you maximise your freedom of action—which you generally want to do—you also run a lot more risk. If you are happy with a £0.5 billion fluctuation in your budget and having to give up several hundred million pounds to stimulate business, there you are. It is not free, if you see what I am saying. You buy your increased freedom of action with a lot more instability of revenue and a lot more risk being run.

That said, I would not rule out corporation tax devolution within a certain framework. Again, you could not have total freedom of action; there would have to be a UK concordat, otherwise there would be a race to the bottom and you would end up cannibalising the whole tax base. There would have to be a scheme whereby different regions of the UK were allowed to cut by a certain amount. We could not just say, "Have it. Do what you like with it."

Brian Adam: Surely everyone has told you that that could be addressed in the same way that volatility around income tax is going to be addressed: through appropriate borrowing during the cycle.

Professor Holtham: In principle, but there would be much more volatility. The problem is not different; it is just of a different order of magnitude.

Brian Adam: The scale of corporation tax is not quite the same as that of income tax. It would depend on what proportion of that tax was devolved. If it was all devolved, what you imply would be correct, but only part of it might be devolved.

Professor Muscatelli: The expert group highlighted the volatility to the Calman commission. It is probably the most volatile of all the major taxes that could be devolved. There is also the issue of tax competition. We reviewed some evidence from Switzerland that showed that, where there is competition on corporation tax, there has been a race towards matching lower rates of corporation tax and a shift from corporate taxation to personal income taxation. That perhaps flies in the face of what we are trying to achieve, which is assigning revenue to maintain some level of similar expenditure on public services.

Tricia Marwick: The UK Government is considering corporation tax flexibility in Northern Ireland at the moment. If the Northern Ireland Assembly is permitted to set its own corporation tax, why do you argue so strongly against that in Scotland?

Professor Holtham: If the Northern Ireland Assembly were allowed to do so, you would have a strong case for having the same facility. However, if I were a betting man—which I am—I would lay you fairly attractive odds against the Government ever allowing that. It has just promised to consider the possibility; I do not think that it is going to agree to it.

Tricia Marwick: The evidence that we received from the Exchequer Secretary to the Treasury and from Michael Moore, the Secretary of State for Scotland, was that the Government does not rule out the possibility of doing it. Michael Moore suggested that Northern Ireland is a different kettle of fish altogether. I did not get the impression, from our discussions with both ministers, that a separate corporation tax in Northern Ireland has been ruled out. If that has not been ruled out, would you say that the Scottish Parliament must be able to set corporation tax in Scotland if we are not to be at a disadvantage to Northern Ireland?

Professor Holtham: That is the point. If the Northern Ireland Assembly were given the ability to reduce corporation tax in Northern Ireland, it would be explicitly because the UK Government thought that the need for economic development in Northern Ireland was greater than in the rest of the UK. If corporation tax were to be used as an instrument of regional policy, bigger cuts would be allowed in poorer parts of the country, so Northern Ireland and Wales would get to cut corporation tax by more than Scotland because their income per head is a lot lower than Scotland's.

There cannot be a complete free-for-all because there would be a race to the bottom. Some concordat or system would have to say by how much different people could cut. If that were based on income per head, Scotland would be allowed smaller cuts than those in Northern Ireland or

Wales. That is just a case of regional development.

Tricia Marwick: However, south-east England—

Professor Holtham: That area would not be allowed to cut at all.

Tricia Marwick: Let me finish my point. Of course that area would not be allowed to cut at all. Income per head in south-east England is far higher than that in Scotland. We would be at a positive disadvantage if Northern Ireland and Wales were allowed to cut corporation tax but we were not.

Professor Holtham: That is the point—those areas would be trying to put you at a disadvantage. That is discrimination in favour of the poorest areas, so of course it involves discriminating against everybody else. That is the policy's whole point.

Professor Vaillancourt: If income across regions is to be compared, it should be real income. After correcting for price levels, the same difference will not always be yielded.

On corporate income tax, if parts of the United Kingdom are less developed and need help, the Canadian experience is of granting in the federal central Government corporate income tax system geography-specific tax credits, such as the Cape Breton Island 20 per cent investment tax credit and the eastern Canada investment tax credit. There is a long history of that. There is no need to devolve corporate income tax to achieve that result—it can be achieved simply by giving credits in the central Government corporate income tax system, which is quite easy to do. If that is the issue in the UK, the committee might want to consider that system, although that is not part of the study of the bill. That is not so much about autonomy, but the question can be answered quite easily.

The Convener: That leaves on the table the question of provincial corporate tax.

Professor Vaillancourt: That is it—I am saying that devolution is not needed to achieve the result that I described.

Peter Peacock asked about personal income tax as a tool of economic growth. I was surprised by that, especially as income tax on savings and distributions are not included. What could be done with income tax to encourage economic growth? In Québec, we have given special treatment to the issuing of bonds by local development agencies, but would that not be a distribution under your income tax system, which could not be handled by that system?

The argument for giving Scotland the freedom to set personal income tax as a tool of economic growth is not very strong. You might raise more revenue by increasing the rate and by spending the revenue on improving rail or road links, ports or whatever is required—that is for you to decide. However, given the mechanisms that are available, I do not think that personal income tax could be used for economic growth.

Brian Adam: Nobody suggests that using just one taxation measure is the key to economic growth; a basket of measures would be involved. That is one reason why some of us suggest that a range of taxes should be available. Even if we relied on one tax, several other measures—some of which you just highlighted—could be used. For example, some of the money that was raised could be spent. The basket of measures would help.

Peter Peacock: I understood that Professor Spahn said in his opening remarks that what matters is how policies are applied—whether to spending or taxation. It has been implied that growth is impacted by how policies are applied, not by the fact that they exist. Devolution of the powers of itself would not give rise to economic growth; that would result from investing in roads, education or whatever. Is that correct?

Brian Adam: As some of our colleagues around the table have said, the greater the flexibility, the more accountability and the better the opportunities to address issues. Policy decisions on spending will also stimulate growth, if that is the choice. A policy driver or series of policy drivers is required to make that happen.

Robert Brown: Is that not just one possible tool? You do not give enough credit to the tax competition restrictions and other restrictions that would apply, even if Scotland were independent, never mind part of the union. It is reasonably clear that tax bases cannot be moved all that much without introducing administrative complexities or arrangements under which the total tax take across the United Kingdom is less. Those issues have been touched on.

Brian Adam: But there is historical evidence to suggest that the current unitary arrangements have led to differential growth in the UK—and it has certainly not been to Scotland's advantage.

David McLetchie: I want to comment on historical evidence and Northern Ireland corporation tax. Professor McLean presented evidence last week. He said that Northern Ireland had the capacity to set corporation tax between 1920 and 1972, and it proved to be a tax avoiders charter. If I recall his evidence correctly, he mentioned the Vestey family, who have had a remarkably successful record in avoiding paying

UK taxes and were particularly good at exploiting the situation—legitimately, I may add, as I do not wish to libel the Vestey family. Will Professor Holtham or others comment on that aspect? Was that looked at in the context of your discussions vis-à-vis Wales, and how could the issue be addressed?

Secondly—this relates to the Northern Ireland dimension—to what extent is the proposal driven by the corporation tax rates in the Republic of Ireland and, in a sense, regional development competition among regions in the one island? Is the disparity between the two Irelands likely to be sustained given the current state of the Irish economy and public finances, which appear to be in an even worse shape than ours?

Professor Holtham: You might have differential rates of corporation tax either as a matter of regional policy or, more likely, because you devolve corporation tax—although the trouble with doing it centrally is that there are all sorts of issues with European Union legislation. Either way, if you have differential rates of corporation tax, you have to make it clear that the rate of tax depends on the economic activity in the area and not where the company puts its brass plate or where its head office is, which are irrelevant. At the very least, you have to use the proportion of the payroll that is paid to people in the area, although there are more complicated formulas, which are used in the United States for example, that look at turnover and where capital investment has taken place. You have to make it clear that if a company is going to enjoy a lower rate of corporation tax, it is because it has activities in the area and not simply because it sites an office there.

The Convener: I am very anxious to move on, so this is the absolute final word on corporation tax.

Professor Spahn: We should not necessarily look at varying tax rates for corporate tax. That is the issue, and it could be a nuisance in the union. In Germany, we have a single tax but the tax base is allocated to the states on the basis of payroll. That makes a state interested in attracting payrolls. Since the war, Bavaria has attracted businesses based on payroll, which are the modern services. It has had remarkable development, even though the tax rate has been uniform. You should not forget that, if you have a formula for allocating the tax base among regions, it can help to stimulate certain activities.

The Convener: Thank you. We will move on to grant reduction. We have already heard from Gerry Holtham some outline of the Holtham commission proposal for a proportionate reduction. Professor Boadway made a different suggestion last week—I know that some of you have had the opportunity to read the evidence. Finally, there is the proposal in the UK white paper promising no detriment. We are trying to explore whether that is right. What about the indexation of the thresholds? How should the plan be developed, and where should it be negotiated on an on-going basis?

The sensible thing would be to allow our outside experts to comment once on grant reduction issues. Gerry Holtham has already offered his view, so who else would like to comment on the grant reduction mechanism?

15:15

Professor Muscatelli: We did not propose a mechanism in our report but, having had the benefit of the Holtham commission’s work, my view is that you should try to insulate Scotland from any changes in the tax base that take place at UK level and, as Gerry suggested earlier, that you should therefore look at ways of indexing the adjustment to changes in the UK tax base. That would take account of the fact that if the UK Government started to play around with thresholds or allowances, that would be reflected in a modification.

I am against what the Holtham commission called the “own base deduction”. In essence, that is what is proposed for the transitional arrangements. The approach basically involves saying, “We’ll insulate you against any changes in your own tax base”, which seems nonsensical, because it defeats the whole purpose of giving more accountability.

The proposal in the Scotland Bill is for a once-and-for-all deduction after the transition period. At the back of my mind is the idea that in the longer term there might be a need to look at the relationship between the grant and the taxation element. Many of us on the expert group thought that after such a reform there would probably be a desire to look at the grant allocation mechanism, which is not currently based on need and might not take account of what happens over longer periods—a decade or more—to relative need in different parts of the UK.

Therefore, either you introduce a mechanism along the lines of what Gerry Holtham suggested in his written submission—so you would have some sort of long stop and then have a look at the relative relationships—or you look at the formula again in 15 to 20 years’ time, to ensure that it still reflects relative need. In the short term, in the context of the bill, I am in favour of not having the transition mechanism, because it does not make much sense. We might get to some of the detail on that later. I am in favour of looking at an arrangement that allows an indexation of the adjustment to the UK tax base—I beg your pardon; I meant to say income tax base—to allow for adjustments to income tax policy by the UK Government.

Brian Adam: What would be the problem with using the adjustments to the UK tax base and not just the UK income tax base? I presume that using the UK tax base would address my concern about shift from direct to indirect taxes, which other people have suggested might be sorted because the grant would go up. Why not use the total tax base?

Professor Muscatelli: That takes us back to the points that were made about how, to some extent, the grant implicitly picks up some of the other spending decisions at UK level. If I understood you correctly, you are concerned about what would happen if there were a switch from direct to indirect taxation. That would be picked up by the sort of indexation mechanism that Gerry Holtham has suggested.

Professor Holtham: Yes. If we think about it, what Brian Adam suggested would work against the devolved authority, because, for example, if the UK Government switched from direct to indirect taxation it might define the tax base as a whole as unchanged, which would not help you at all, whereas if it reduced the income tax base it would have to increase your grant. Income tax is what is devolved; therefore that is what is threatened if the Government alters the base in some way. You can build in automatic compensation via the block grant, so that if the Government messes with the income tax base it can be corrected. It is better for the devolved authority to index to the same tax base that is devolved; that protects you from that tax base being manipulated.

Robert Brown: There is no perfect solution—I said that in a more general sense in the context of income tax. I presume that most systems have to make more structural changes to the grant formula from time to time, as oddities occur and are built in over five, 10 or 15 years. I would appreciate hearing about the international experience in that regard.

I am conscious that the paperwork does not give us much guidance on the issue, other than to say that the figure for tax income at the start point is based on a number of years—I think that that takes away the £8 billion issue that we have been hearing about from the Scottish Government. Leaving that aside, there seem to be two sides to the negotiation with the Government: one is to do with the start point and how things go on from there; the second is about whether more clunky adjustments need to be made from time to time on a more structured basis, as whatever formula was entered into leads to oddities over time. Is that the experience of other jurisdictions internationally?

Professor Vaillancourt: In Canada we are much nastier than that. The federal Government will change a tax base by introducing tax expenditures or increasing the personal exemption and that is it—the provinces adjust. If you want more revenue, given the change in tax base, you just have to increase your tax rate. You might want to say that there is an implicit contract, whereby eventually the equalisation grants will be adjusted, but that is certainly not explicit. There is no indexing, no relationship, no formula. There are examples—1972 and 1977 are very good ones, but there are others—of the federal Government just saying, "Sorry. For my purpose, I need to do this." Alternatively, if the tax base has increased and there has been a desire to reduce tax rates, it has said, "Go ahead."

That would not be appropriate in this case, but I think that the answer that was given on the appropriateness of using the UK income tax base is correct. You are trying to find a mechanism to adjust an overall grant to take account of the fact that part of the UK income tax base—the part of it that is raised in Scotland—will no longer be part of the funding of that grant. It will not be given to you directly. Such indexing would do away with the issue that was mentioned in the command paper, whereby any policy change would mean that appropriate adjustments would have to be made. All that would be done automatically. If the UK personal income tax base went down by 5 per cent on a per capita basis, the grant would be adjusted to take that into account. If the tax base were more generous and the number of exemptions were brought down, such that more personal income tax would be generated, it would go the other way. It is a beautiful solution.

Robert Brown: It would solve most of the problems.

Professor Vaillancourt: Yes, there is no arguing over that. It is a clean-cut and clear solution. I think that it is a wonderful and very original idea.

Professor Holtham: It does not solve the problem, but it has the advantage of reducing the problem of the initial estimate that the UK Government makes about what the Scottish tax base is worth. If that is cyclically distorted—if it is too high or too low because Scotland is at an unusual cyclical point—and the UK Government does not give you enough or it gives you too much, as long as the Scottish economy is in the same cycle as the rest of the UK, as the UK recovers or comes off the boom or whatever, its tax base will change and that will be fed back automatically via the indexation. To some extent, that will offset any errors in the initial calculation of what the Scottish tax base is worth.

The Convener: Let us move on to short-term borrowing. We might come back to the transition mechanism, but I am keen that the borrowing issues get an airing.

Professor Spahn: The short-term direct borrowing proposal is probably motivated by the desire to smooth the tax developments. The mechanism that is proposed is a smoothing mechanism because the income tax would not be handed over month by month as it was collected; it would be provided on the basis of a forecast, which would be made in advance and put into the Scottish budget. On the basis of that budgeted amount of money, Scotland would get contributions from central Government. After the event, there would be a reconciliation based on the taxes that were actually collected. That mechanism is found in Scandinavian countries. I have met it in Denmark and Sweden, and it works fine to mitigate the vagaries of the business cycle. Therefore, I think that once such a mechanism is in place, there is less of a need for short-term borrowing for tax smoothing.

At this morning's session, we discussed the possibility that the mechanism will have to be refined because, as proposed, it relates to four-year spending periods. Making a forecast for four years is relatively tricky, and I would not bet that the fourth year would be on track. As you go through the spending period, there will probably be deviations. I propose that the option should be looked into of having a mechanism that is more in line with events and which is revised annually. I think that such a mechanism would reduce the need for short-term borrowing.

Brian Adam: Is it not true that the current arrangements would mean that we would use up more than the current capacity? The gap for this year is bigger than the capacity that is available over a four or five-year cycle. The overall capacity to borrow to meet short-term needs appears to be inadequate.

You highlighted the spending review periods, but the UK cycle is not necessarily the same as the Scottish cycle. We tend to go down later in the cycle than the UK does and to come up later. Our dip is sometimes shallower and sometimes it is sharper. Is there any evidence in terms of how we might tackle Scottish cycles rather than just UK cycles or, indeed, spending review arrangements? Should there not be a mechanism for that? Is there a need for research in that regard?

Professor Spahn: Do I understand your question correctly if I say that it is a matter of who does the forecast and whether we have a forecast for the Scottish economy that is separate from that for the rest of the economy? A regional forecast would, of course, take care of the matter. You say that Scotland's cycle is always a bit behind events. That gives you information on what happened in England last year and you make your own forecast, as the Treasury does its forecast. If that is the core of your question, then the answer is to make different forecasts for different regions.

Professor Muscatelli: I will support what Bernd Spahn said. Forecasting for two, three or four years out, especially over the last period, would have led to very erroneous forecasts. Why not introduce a system of more rolling forecasts, which I think would be better? What Mr Adam said is absolutely correct. We need to look at the proposed size of the mechanism, because if such a system had been in place over the past couple of years, it would not have provided enough finance. It needs to be big enough to handle most situations, which would have nothing to do with mistakes made by the Scottish Government but would simply be the result of a cycle. It would need to be adjusted.

Brian Adam: Do you also agree that we need to know something about Scottish cycles as well as UK cycles and at least have an evidence base on that?

The Convener: More work for economists in Scotland—I am sure that he will agree.

Professor Muscatelli: If you looked at the calculations in the paper that was submitted by, I think, the UK Government, I am sure that you could go back and trace how they compared to some of the forecasts. We presented some work on forecast income tax versus actual, where you can see that there are certain divergences. You could therefore pretty quickly find out what the size of the short-term borrowing requirement would need to be.

Professor Vaillancourt: It is a mystery to me why short-term borrowing cannot be above £500 million—perhaps someone can explain that. What is more important, however, is that we are talking pessimistically about borrowing. Let us assume that things go well: you will have a surplus because your forecast for income tax money will be lower than the realised sum. What happens to the surplus? Do you keep it, or does it roll over at the end of the year to Westminster? If I understand it, rolling over is currently allowed, but it is not a right of the Scottish Parliament. When it is your money, however, how will you differentiate it from the grant? One of the normal consequences would be that, at the end of any year, any surplus—whatever the source; it will be commingled and the source will be impossible to identify—should be kept by the Scottish Parliament to spend. You should build up your own cash reserve, which should not be part of the Westminster Administration. That is very important.

Professor Holtham: Absolutely. If you got that done, it would be not just a matter of detail but a radical change. Once the Westminster Government had voted the money it would be yours. It would go into an account somewhere and the UK Government would not be able to claw it back. If you do not do that, you run into the problem that François Vaillancourt pointed out, which is that if you underspend on grant money, Westminster can take it back—but how do you tell grant money from tax money?

Brian Adam: If there was an underspend in the first two parliamentary sessions, the end-year flexibility was retained by the Treasury and released only with its agreement, because it wished to have some say on how the money was spent, so I sympathise with your point. It is not quite as rigid as that now but, nevertheless, the Treasury retains an element of control.

15:30

Professor Holtham: It would be an important juridical advance if you could secure that.

The only other point that I make is that you have two buffering mechanisms. One of them has already been talked about. If you have a rolling forecast and there is an unexpected drop, you will not have to put up with it. You will get the money in the forecast. There is a certain amount of buffering there, and if you move to indexing your grant deduction to the UK tax base, that will be another source of buffering, because if that tax base drops unexpectedly, that will be compensated for in your grant.

The position is not desperate because there are a couple of buffering mechanisms in place, but the basic point is that, as Anton Muscatelli said, you should have a look at how big the forecast errors are and how big the divergence of the Scottish cycle from the UK cycle has been. You just need to do some simulation. It is not justifiable for the UK Government to suck some number out of its thumb. It has to justify the number with the sort of analysis that I have mentioned.

Brian Adam: Would it be useful to have research on the economic cycle in Scotland and how it relates to the UK cycle? Would that help with building in a forecasting mechanism?

Professor Holtham: Yes, and research on forecast errors, too. Absolutely.

Professor Spahn: It is not as important as you might think. The Danish municipalities do not necessarily make an economic forecast of the activities in their jurisdiction. They make a budget forecast of what they expect the revenue to be. How do they do that? It is probably done very much out of their thumbs. As long as they have an autocorrective mechanism, they will not overstate the requirement. They know that, if they do that, they will get the money this year, but next year they will be in debt to the central Government. Anticipating that, they try to gear the revenue according to their needs on the expenditure side.

As long as you do good budget forecasting on the expenditure side, you can live with it. You do not really have to understand the business cycle of the Scottish economy.

The Convener: We will move on to capital borrowing. People might have things to say about the transition mechanism at the end, if we have time to discuss it, but I think that the capital borrowing side is much more significant to the committee's deliberations.

Professor Holtham: Again, my first remark is that the UK Government has produced a number, but it was sucked out of its thumb. I do not know where it came from. It seems to me that the right consideration is to say that the capital allocation within the Barnett grant is at least partly financed by UK-level borrowing, so the additional borrowing that it is legitimate for Scotland to make is the capital expenditure that it wants to make over and above that capital allocation, and that will now be underpinned by its own tax capability.

If you want to know what the capital constraint should be, look at the revenue that you will get from borrowing and ask a question like, "What is the maximum percentage that it would be prudent to spend on debt servicing?"

Professor Vaillancourt: Of personal income taxation.

Professor Holtham: It is a matter for you, but you might decide that you would not want to spend more than 5 per cent of taxes on debt servicing. If taxes are worth £5 billion, 5 per cent of that is £250 million, so you would not want to spend more than that. If the interest rate is 5 per cent, you get to £5 billion.

I have just sucked the numbers out of my thumb, but the point is that there would be a series of steps like that. You ask the question. You know what your tax base is. You can stress test how much it might vary. You have to set a prudential limit for interest debt. You then have to work out what is the worst thing that could happen to interest rates.

The Convener: It may explain how we got to £5 billion, being £3 billion plus £2 billion.

Professor Muscatelli: I agree, except that, as Gerry Holtham pointed out, the £3 billion is the part that comes from the grant allocation. That suggests that £2 billion is a bit of an underestimate and you might want to give the Scottish Parliament more room for manoeuvre. If the calculation gets you to around £5 billion, whatever the serviceability calculation, that is what it should be. It should not be based on some other, exogenous element.

Brian Adam: In connection with that, very shortly £1 billion a year will go to service off-balance-sheet borrowing for private finance initiative/public-private partnership projects. What influence would that level of debt repayment have on the Government's capacity to borrow for the future?

Professor Holtham: As I understand it, that is Barnettable. In other words, if the UK Government is spending on PFI deals money that is coming out of current expenditure because the deal is treated like a lease or something, Scotland gets its share of that when the spending is in devolved areas. Whether your own PFI is higher or lower than what Barnett would give you, I do not know.

Brian Adam: It is higher. Scotland made a lot of decisions about how it was going to finance things that meant that we chose, as a proportion of our income, to have rather more such deals. Obviously that has implications, unless there is a mechanism to correct it.

Given that we already have that level of borrowing, how do you feel about the use of bonds? A lot of these issues are about the best way to raise money. I suppose that you could argue that there is a track record; we have borrowed lots of money and we are paying for it through the PFI/PPP payments, so we would have some kind of track record when we went to the market.

Professor Holtham: Government bond issuance is genuinely cheaper than doing PFI, but if you have these long-term liabilities you would prudently take them into account when deciding how much of your budget or tax receipts you want to devote to debt service.

David McLetchie: On this issue, and comparing a devolved Scottish Government raising money by issuing bonds with the UK Treasury doing the same, is it the experience in countries with federal systems that the cost of borrowing is higher for the subnational Government? If we had a bond-issuing capacity, would we end up paying more for it than the UK Treasury would for raising the same money, which we could presumably then borrow from the UK Treasury? Is that the case?

Professor Holtham: We got a couple of investment bankers in and said, "We're the Welsh Government and we want to issue a bond. How much will you charge us?" They said, "45 over gilt." Scotland might be a little more creditworthy than Wales—say you are 40 basis points over gilt. In general, if you issue your own bonds you will pay slightly more. What I found very surprising was that the Debt Management Office is extremely accommodating. If you go to it and say, "I want to borrow at six and three quarter years," it will not issue a six-and-three-quarter-year gilt, but it will lend you at six and three quarter years and will then issue five and 10-year gilts and it will take the risk of the mismatch between its loan to you and the loan in the market. It will also lend to you at fixed rate or floating rate or through sinker or vanilla bonds. It would be unusual for you to find it a better deal to issue your own bonds. If you want to be able to do that for demonstration purposes, that is fine, but generally speaking, financially, you would not do better than borrowing through the DMO.

Robert Brown: Is there any macroeconomic reason why the Scottish Government should not have bond-issuing powers, in terms of the UK's borrowing, bursting limits and all that sort of stuff?

Professor Holtham: No. Once you set a limit, whether you borrow through the DMO or issue the bonds yourself should not be a matter of concern to the UK macroeconomic authority. However, you would be paying for vanity if you issued your own bonds at this point.

Peter Peacock: On that point, one of the bits of evidence that we got last week was that rather than having an agreed cash limit for borrowing in relation to bonds, you would let the market dictate how much of a risk it reckoned you were. That would price you out at a certain point because you would not be able to afford to issue bonds at the rates required or to cover the risk. Is that a reasonable alternative to a limit?

Professor Holtham: No. The markets price you out when you are already bankrupt. Just look at the situation—you simply cannot rely on them to react in time. Indeed, they will not react until they want to kill you.

Professor Muscatelli: As Gerry Holtham said, it is always difficult for the market to genuinely assess the risk and, with subnational Governments, there is always the implicit feeling that national Government will come in with a bailout, which artificially depresses the interest rate on such bonds.

Professor Vaillancourt: The national evidence from Canada and the US suggests that borrowing is more expensive for provinces or states than it is for the central Government. Moreover, those bodies have no access to a central bank and are rated not triple A but double A plus or whatever. However, we do use the market. I realise that this might be a bit too close to issues that are going on in Europe at the moment, but I have to point out that there are no bankrupt provinces in Canada. In any case, I would be cautious about generalising from the experience of borrowing by Portugal or

Greece, which are sovereign not subnational countries. Some US states are in bad shape, but they are trying to correct themselves. The US federal Government provided a partial, temporary bailout of the state budget, but that is being phased out—indeed, this is the last year—and we will see the real impact next year. However, the reaction over there has been, “Well, we’ll do this,” and, as I said, the provinces have borrowed with no problem. That said, I agree that the amounts involved are not in themselves a justification and, if the UK is giving a share of taxation powers to a subnational Government and the Scottish Parliament, that Government and Parliament should have a share of access to the market.

You make a very interesting point about the £1 billion for PFI and PPP. Is that to reimburse borrowing or to pay for the use of facilities?

Peter Peacock: Both.

Professor Vaillancourt: Then if the tax revenues are 20 per cent of your budget and the grant 80 per cent, I suggest that £200 million of that £1 billion be charged to the borrowing capacity associated with the devolved tax. After all, the decision on this spending was taken before the tax was devolved. If the grant that would have entirely financed that spending will be reduced, you will have to correct the borrowing capacity off your tax revenue and go with the remainder.

Brian Adam: The whole point of PFI and PPP was to take these things off balance sheet. Of course, such a choice is no longer realistic. Nevertheless, the market pricing mechanism for the system was above the Public Works Loan Board rate and, in some of the early projects, there was considerable concern about what that rate was. For most, the term of the debt was 30 years; the peak repayment for servicing it is coming up quite soon—I cannot recall the exact year, but it is in the foreseeable future—but it will amount to £1 billion a year and will take some time to work its way through. That said, we will establish some creditworthiness or capacity to borrow against that should we either go to the market directly or issue bonds.

The Convener: Given the time that we had, we have not done that badly in flagging up all the issues that we wanted to cover. Perhaps we should use the last couple of minutes to allow our expert witnesses to put on the agenda issues that they have not had the chance to mention and, more important, to allow our members to ask certain questions that they want to raise with the witnesses.

Before we end the session, I point out that we always invite expert witnesses to follow up in writing any issues that they feel have not been fully explored or that they wish to clarify. I extend that invitation at this point, but I should add that we are driving to a very tight timetable.

Robert Brown: There has been and will be a lot of negotiation between the UK and Scottish Governments on the effects on and changes to the grant mechanism and whether there will be any detriment in that respect. Can Professor Holtham in particular tell us how robust the intergovernmental arrangements are and whether they provide equality of arms and allow a kind of principled decision-making process on outstanding disputes—of which there will be many, as there always are in these situations?

15:45

Professor Holtham: I do not think that the arrangements are very robust. Other people have correctly said that there is still a perception in the bureaucracy in Whitehall that the devolved authorities are just like other Government departments and that they can be treated as such. That mindset still exists. As part of the process of changing that mindset, it would be good to have slightly more formalised dispute resolution mechanisms.

It is sometimes better to get in early in the process than to have an end-of-pipe resolution. That is why things such as aspects of the determination of the Barnett allocation, for example, would ideally be determined outside the Treasury by the Office for Budget Responsibility or some other body that is at least notionally independent. That would be a great step forward.

We have already mentioned that there ought to be a separate bank account for the Scottish Parliament into which funds are paid. Once those funds are in that account, the Treasury should not be able to have them back. Institutional changes would be needed to reinforce that.

Professor Spahn: We have also discussed the issue with the Office for National Statistics. It is interesting that the second tier is not in the national or public sector accounts. The fact that devolved authorities are being treated like a central Government department does not show up in the statistics—or it shows up in them, but what you want is a second tier: this is central Government, this is regional government and this is local government. We have been told that that is easy to do; it is simply a matter of political will.

Professor Holtham: As far as the Office for National Statistics is concerned, it is also a question of budgets. However, I agree that there ought to be a third tier of government in the UK, and it ought to be in the national accounts.

Peter Peacock: My question is simple. Is there a link between the decentralisation of revenues and improved economic growth? Is there any evidence of that link? Is there evidence that one follows the other?

Professor Vaillancourt: As Bernd Spahn said earlier, no. There is no evidence relating to decentralisation and economic growth that really stands the test of time. One paper will say that there is no link, one will say that there is, another will say, "I'm not sure," and a fourth will say, "This way I get it; this other way, I don't." I refereed a paper last week on that issue, which cited all the literature. There were three paragraphs, for the yeas, the nos and the don't knows, and around four or five studies on each.

I think that the international experience—Bernd Spahn may want to add something about this—is that, in some countries where there has been good governance, decentralisation has led to an improvement in governance because the matching of preferences, local knowledge of needs and appropriate local measures to meet those needs and preferences has been better than that obtained by the central Government. Decentralisation will then have a positive impact on the quality of public services, the siting of roads, the proper dredging of harbours and whatever else you can think of, and that can improve economic growth. If there is not good delivery of services, there can be waste. There is a big debate at the World Bank about whether it is easier to fight corruption at the local level or the central level, and what measures are easier to implement. The evidence goes both ways.

The fundamental answer is that you are not doing what you want to do for improved economic growth; you are doing it because you believe that it will give you better governance, which may lead to improved economic growth in the long term. People may think that there will be a 0.5 per cent increase in the Scottish GDP permanently as soon as 2015 because of the devolution of part of personal income tax, but I am not willing to bet on that, as it is impossible to measure what will happen and to know who would win the bet.

David McLetchie: Your positive examples were based on the decentralisation of expenditure and the expenditure decisions that would be taken by a subnational Government in relation to transportation, education and so on. I do not want to put words in your mouth, but I think that the live issue is about the decentralisation of tax-raising powers, because we already have significant decentralisation anyway.

Professor Vaillancourt: If decentralisation had an impact on growth, that would be where the most likely channel would be to target taxation better. It is difficult to say that the way in which the decentralisation of expenditure is being discussed now would not make sense. If you are willing to have decentralised corporate income tax and allow a race to the bottom so that Scotland becomes a haven for people who move here because the rest of the UK has a higher corporation tax rate, you might buy false growth, until someone else does the same thing. Think of Ireland.

You want fundamental growth, good human capital and good physical infrastructure. If you have those things, businesses will come to your country or your region. If you just try to move capital around, that will not work. There is the famous example of Puerto Rican pharmaceutical companies that close their doors the day after the tax exemption ends because they have no reason to be there. Is that economic growth? No, it is just short-term employment.

Professor Muscatelli: There is absolutely no statistical relationship between fiscal autonomy and growth, nor can there be. If you look at the range of variables that influence that relationship, you can see that all you have to do is change the data slightly and you will get a different result.

Really, I question whether it would even be interesting to ask such a question based on a cross-sectional set of data, because, as Professor Vaillancourt says, what you are interested in is making the case for better governance and better systems of spending money or raising taxation. The detail of that is what is likely to impact on economic growth and improve economic performance. I find it unsurprising that there is no example of what you are talking about across 20 or 30 Organisation for Economic Co-operation and Development countries in the past 30 years. Would we expect to find one, given how many variables are flying around?

Professor Spahn: There is some casual empiricism. I usually give the examples of Lorraine in France, Saar in Germany and Wallonie in Belgium, which were all problem areas after the second world war, and compare them with Luxembourg, which did not have anyone to help it out, so it had to be inventive and generate something new to make its economy survive. Luxembourg totally restructured its economy after the second world war, whereas those other regions, which were in a comparable situation before the war, did not, because they knew that their national Governments would bail them out.

That is an illustration. It is not empirical evidence, but I usually use that as an example.

On the other hand, with regard to decentralisation, what usually happens is that regions that are economically powerful tend to be a threat in terms of secession. Scotland is an example of that, as is Aceh in Indonesia. If such a region gets more autonomy as a result of political pressure, it will do better than the rest of the country. That is not surprising, because it has those resources and, without them, it would probably not claim independence or more autonomy.

The issue depends on a number of factors, and I would not make a general statement on the matter.

Professor Holtham: Changing taxation could conceivably make a contribution to economic growth. Taxation is distortional and discourages people, but it gives you money to do things such as put in place infrastructure. You have to balance the two sides and try to find an optimal level of taxation.

It is not necessarily the case that the British Government has got the level right for Scotland. It might be that the appropriate level of taxation for Scotland is a bit higher or a bit lower than it is at the moment. Tax devolution gives you the ability to make that change, so it is conceivable that it could make a contribution.

The reason why you cannot generalise about the issue is that, as we have said, autonomy gives you more things that you can change and more room to manoeuvre, but it also exposes you to more risk.

The point has already been made that it is the way in which you use autonomy that determines whether you grow; some people do it badly, so their growth is worse. The other bit is risk. If you have taken on more risk and you are hit—bang—by a hurricane or tornado, it is bad. An element of luck is involved. That is why it is impossible to generalise.

Brian Adam: I thank the witnesses for coming to today's meeting. I much appreciate the fact that some of you have travelled long distances. It is unfortunate that not everyone who was invited felt able to come, perhaps for understandable reasons, but I appreciate the effort that you have made. I have found your evidence stimulating.

There is a debate about whether a change in tax rates can produce growth, but we cannot look at the issue in isolation. It depends on what the Government's priority is. If it is to stimulate growth, in order to grow revenues to deliver better services, the Government has a much better chance of achieving growth. Inevitably, if the Government has more fiscal powers, it has a better prospect of achieving that, provided that it makes the right choices. I accept absolutely that it must make the right choices. However, if the Government does not have growth as an aim and has fewer powers, its chances of achieving growth will be reduced. It may do so through happenstance, but to achieve growth it must have that as a goal and have the necessary powers.

I invite Professor Holtham to comment on two points that he makes in his submission. First, he suggests that

"Scottish government policy may well affect the growth rate of its own tax base relative to that of the UK, notably if it alters its own devolved tax rate."

That runs contrary to what some other witnesses have said today. I would like him to expand on the point.

Secondly, when discussing the implications of the income tax powers, we did not really cover Professor Holtham's suggestion that

"raising taxes becomes much more attractive than cutting them",

because raising taxes produces a smaller reduction in grant than lowering taxes produces. Am I misreading the point?

Professor Holtham: What you say is true of the interim arrangement. I argue that indexing the grant reduction to the Scottish tax base introduces a strong bias. People have expressed scepticism—they may be right to do so—about the extent to which moderate changes in taxes impact on the base, but at least we know the direction. If you put up tax, the base will not grow relative to the way in which it would otherwise have grown; if anything, it will do nothing or will shrink a bit. If grant reduction is indexed to the base, I do not care if my base shrinks when tax is put up, because that shrinkage is covered by the fact that I will be paid a bigger grant. If I do things the other way round and cut tax, I take a hit on my revenue, in the hope that that will generate more activity and a bigger base—too bad, chum, because if the base increases, the grant deduction will increase with it, because the deduction is indexed to the base. That means that there is a bias in favour of raising rather than lowering taxes.

Brian Adam: That is the essence of some of the Cuthberts' evidence, which suggests that, paradoxically, the UK Treasury would benefit from any rise in growth that was produced by a cut, along with other measures, but the Scottish budget would shrink.

Professor Holtham: That is true only under the interim arrangement. Under the long-term arrangement, you do not need to worry too much about any rise in growth that benefits the UK—unless you really hate it—because, basically, you are benefiting yourselves. Under that arrangement, the two things are compatible. If you cut tax and grow the base, the UK will get a bit of the benefit, because it shares the base, but you will also get benefit. Only the interim arrangement is completely pernicious.

Professor Muscatelli: To clarify, the Cuthberts' point was a little different, because it was not to do with the grant reduction; it was to do with the response of income tax take to different changes, which is almost a Laffer curve effect. In essence, it was to do with the elasticity of the response.

16:00

Tricia Marwick: All our experts have said that personal income tax is the place to start in giving the Parliament more fiscal responsibility, but every single one of you has expressed concern about some of the mechanisms, such as that on borrowing, and some of the analysis that the UK Government has—or has not—done. There seems to be a suggestion that the limit of £2.2 billion on borrowing has been plucked out of thin air.

What one thing would you suggest to strengthen the bill? What would be your number 1 priority to strengthen it to give the Scottish Parliament as much responsibility and protection as possible, perhaps even from the bill's inadvertent consequences?

Professor Muscatelli: If you forced me to choose, I would choose making the grant reduction mechanism robust in relation to changes in the income tax base in the UK and removing the transition period. That is the highest priority, because otherwise the measures will cause a lot of resentment and potential conflict. Fixing that would take out a lot of the conflict and would create an adjustment mechanism that was acceptable and transparent at the outset. However, a close second priority would be setting proper limits on the borrowing requirements.

Professor Vaillancourt: My first choice would be the same as Anton Muscatelli's. My second choice would be to ensure that you keep the money over years, so that you can build up a reserve and it no longer goes back to the Westminster budget. The commingling argument is the way in which to get the Treasury to agree, because it will be unable to distinguish where the money comes from once the system has been implemented. That is important for long-term responsibility. If people can take away your money on a whim, that does not make any sense.

Professor Holtham: I will be greedy—there are three things that I would do. One is the same as Anton Muscatelli's suggestion: get the budget offset mechanism right. That is fairly simple and I do not think that you will get a lot of hassle from the Treasury about that, because what is it to the Treasury? I believe that the Treasury will do that. I also suggest getting rid of the interim measures, although I do not know whether the Treasury will do that.

I agree that you should certainly ensure that your money is your money. That is terribly important—but good luck with that. The next step would be to ask for a situation in which Scotland has the same share of each income tax band and at least a limited right to change the bands differentially.

Professor Spahn: I have nothing to add. I share those priorities.

The Convener: I thank our witnesses for their evidence. Perhaps one evidence session follows another, because we invested a large amount of time last week trying to establish whether in the academic literature there is a robust academic base for the link between fiscal decentralisation and growth, and we have certainly heard some definitive evidence on that from the witnesses today.

I suspend the meeting for a moment or two and invite our next witnesses to take their places.

16:03

Meeting suspended.

16:09

On resuming—

The Convener: I am pleased to welcome to the next part of our meeting Sir Kenneth Calman, the former chairman of the Calman Commission on Scottish Devolution, and Iain McMillan, a former member of the commission. Does either of you have any short opening remarks?

Professor Sir Kenneth Calman (Commission on Scottish Devolution): It was a privilege to chair the Commission on Scottish Devolution, and I am delighted that a bill has been introduced as a result. Our remit was set by the Scottish Parliament. An amendment to the remit—that the commission should consider independence—was defeated, although I would have been delighted to develop that topic had it been included. The process began with no fixed agenda; it grew from evidence received, visits, meetings, submissions and so on. An interim report was prepared and widely distributed. It was the people of Scotland who generated the agenda and I am grateful to all who contributed. The report's conclusions were unanimous.

Four big themes emerged in addition to the general comment that the Scottish Parliament had been a success: the Scottish Parliament itself; the devolved-reserved boundary; finance; and relationships between Parliaments and Governments. The commission had a majority of non-political members and six members nominated by three political parties. At no time did I feel that I was under any pressure to come to any particular conclusion. Indeed, I would have resigned if that had happened, as would, I am sure, the other members of the commission. I have no party-political affiliations and the conclusions that we came to were based on the evidence presented to assist the Parliament to serve Scotland better.

When the report was concluded, it was presented to the Scottish Parliament and the UK Parliament for debate and discussion, and this scrutiny committee is an important part of that process. I must say how much I enjoyed the evidence-taking session with the previous panel, particularly Ms Marwick's final question, which crystallised some of the issues that could well be developed through the scrutiny process. It is important to note that the commission recommended that if implementation went ahead, the process should be introduced carefully stage by stage and should be managed carefully. That came through in the previous session.

Finally, and this is important, the commission has not met since 2009. Therefore, there is no formal commission response to recent debates in the press or academic journals beyond what is in the report. I have kept in touch with the situation via press coverage, but I have not spoken or taken part in any debates on the matter since late 2009. I have not read in detail the economic literature since then and might not be able to answer all your questions in the same detail as the previous panel did. I know that the committee met that panel at today's seminar and, as I said, it was impressive to hear how things might be taken forward.

Iain McMillan, who is the director of the Confederation of British Industry Scotland, might want to say a word. As the convener said, he was a member of the commission. He served on the finance group and the functions group as part of the commission's work.

Iain McMillan (Commission on Scottish Devolution): I do not want to add too much because I echo in every respect what Sir Kenneth said. Unlike him, I have contributed to the debate from time to time on behalf of the CBI, but not as a member of the Calman commission. As he said, the commission has not met since we reported in June 2009. I simply add that I am pleased that the committee has invited Sir Kenneth and me to be here today. We are very happy to assist the committee and will answer your questions as well as we can.

The Convener: Thank you. I will kick off the questioning. In light of the remarks that you have both made, I invite you to comment in a personal capacity, given that the commission has not met for a year or 15 months.

The legislative consent memoranda before us deal with some of the areas, particularly on the non-financial side, that were included in the Calman commission inquiry, but which have not been included in the bill. Which of your recommendations were you most disappointed at not seeing in the bill and why? Might we want to reconsider them in our deliberations?

16:15

Professor Calman: I was impressed at how many of the recommendations were in the bill. Having been through a similar process with reports in another place, I thought that that was important.

Some recommendations—and not others—have come up in the press, such as the one on air-guns, which we did not make very specific and which seems to me to be reasonable, and the one on the speed limit.

The issue of legislative consent is quite important. It was an important part of the commission's report that the reverse Sewel motion could happen, and that Scotland could—we got some evidence on this—legislate on reserved matters when appropriate. It would be a pity to lose that part of the report.

Some elements, such as the borrowing powers going up, are perhaps better than we might have expected. I was listening to the financial debate just now, and it seems to me that there are one or two things that might well tighten up the scrutiny process in a positive way.

Tricia Marwick: I want to come in on that point. I recognise that not all the recommendations in the Calman report need legislative powers, but do you have a figure for how many of them have not been taken forward? You have mentioned a few.

Professor Calman: I do not think that I do. Some of them, of course, do not need to be taken through the bill—they must go through the Scottish Parliament, so it is not for the bill to handle them.

I have been through the bill, and I think that all the recommendations are covered in most aspects, so I am afraid that I do not have a figure for you. Iain McMillan might have.

Iain McMillan: I cannot give a figure, but I can cite a number of the recommendations in terms of required legislation. The aggregates tax and the air passenger duty, for example, were not taken forward in the bill, although the UK Government said that when the European judgment in respect of aggregates taxes is through it hopes to devolve that one. The policy in respect of air passenger duty still has to be developed and agreed, and something may happen there.

We recommended that half the yield from the tax on savings and distributions should be assigned, but that was not taken forward. The command paper seemed to suggest that that was principally because it would be too difficult to do it. That is fair comment: much of the taxation on interest on savings and distributions is taken at source from banks and companies distributing dividends, and HM Revenue and Customs is not always aware of those who are receiving those dividends, particularly if they are paying the basic rate of tax.

There were difficulties around that, but it would have been possible for the UK Government to propose an estimate—because we had an estimate in the Calman report—of the proceeds of those taxes, and there could have been some kind of sharing arrangement. It could be argued that the UK Government dismissed that proposal a little too readily.

We made proposals on the natural environment and rural affairs, but the command paper makes it clear that the UK Government is working towards devolving some of those areas in April this year.

We made recommendations about the discretionary elements of the social fund and the deprived areas fund, but the UK Government said that those would be introduced in the welfare reform bill at Westminster this month; I do not know whether that is still on course.

We proposed a number of things around charities; there were three specific recommendations. Again, the UK Government did not reject the proposals—it said that a review of the Charities Act 2006 would be put in place and that, although that act applies only in England and Wales, it would look at mopping up the Calman recommendations around charities in that review.

There is also a rather long piece in the command paper about food content and labelling, which takes a bit of reading. Although divergence in policy between Scotland and the rest of the UK is deemed by the UK Government to be extremely difficult and unlikely, policy divergence is still possible to an extent although Calman wanted schedule 5 to the Scotland Act 1998 to be amended to rule it out.

That is where we saw the principal differences.

Professor Calman: My reading of the bill suggests that many of the things that are not in it will be picked up in a number of different places, as Iain McMillan said. It seems entirely appropriate for this scrutiny committee to continue to keep an eye on that; indeed, so should the Scottish Parliament.

Tricia Marwick: Thank you for that. The reason that I ask about the recommendations—I am well aware that not all of them need legislative powers—is that, when I asked the Secretary of State for Scotland that question, he could not tell me. I had hoped that you would be able to give me a more definitive response, but it seems that neither party can.

Professor Calman: I thought that Iain McMillan gave you quite a full response, did he not?

Tricia Marwick: He certainly gave me a full response on some of the recommendations, but not a number.

Let us go back to the recommendation on air passenger duty. The UK Government says that there is a review of air passenger duty going on at the moment, which is why it cannot be devolved at this point. Do you agree that whatever replaces air passenger duty should be devolved?

Professor Calman: It is entirely proper that this scrutiny committee picks that up and makes that point.

Iain McMillan: I agree, although I have a slight reservation. It would depend on what replaced APD. It could well lend itself to devolution, but if it did not meet the criteria that Calman set regarding the immobility of such taxes, there may be a case for reviewing that. Certainly, however, our default position would be to support the devolution of that duty if at all possible.

Professor Calman: It would be exactly the same for the aggregates tax. I think that the Scottish Parliament should have a role in that process. Once the European legislation is clear, there will be an opportunity to consider devolving it.

Tricia Marwick: Thank you for that response. I was going to come on to the aggregates levy. When Calman made that recommendation, the issue was already being considered by the European Commission. In essence, nothing has changed. The Commission is continuing to make its recommendation, and I happen to know that it should go ahead.

Do you think that it would be useful for the committee, in questioning the UK ministers when they come back, to ask for some timeline and timescale according to which they intend to act on some of the recommendations that they have not completely ruled out yet?

Professor Calman: I do not have a problem with the committee doing that, although any timescale will depend on one or two other things, such as how speedily the European Union gets through its issues. Air passenger duty could be put on the table but, as Iain McMillan says, the point is to ensure that the principle of devolving it remains appropriate. If so, the answer is yes.

Robert Brown: In the previous evidence session, I was struck by the comment that one or two people made, that there is an air of the Scottish spending being a sort of Westminster departmental spending—that that is the way in which the Treasury views it. In the context of borrowing limits, how the grant is worked out and other things, there will be a number of areas in which there will be negotiation, discussion, judgment and the application of principles. I have two questions on that. First, in retrospect, do you think that the principles of dispute resolution—the joint ministerial arrangements and so on that were worked out in the Calman commission—are adequate or do they need to be developed? Secondly, particularly on the question of the borrowing powers, do you think that the principles have been sufficiently identified, as opposed to a figure having been plucked out of the air for the capital and smoothing borrowing powers?

Professor Calman: The discussion on borrowing powers that you have just had was extremely helpful. If I was convener of the committee, I would want to pick up on it, clarify it and go back to something that might be more definitive than the figure. That would be a helpful thing to do.

What did your first point relate to?

Robert Brown: The point was about the mechanisms for resolving disputes. Is it not a case of the UK Government saying to the Scottish Parliament, “This is it on the grant, and this is it on the borrowing power. End of story”? Should there be more scope for manoeuvre?

Professor Calman: There needs to be scope for manoeuvre. The question is whether writing down complicated ways for people to talk to each other is a way forward. Sometimes that is about people, and part of the Calman report was about the respect agenda. The two Parliaments and Governments need to respect one another, and if there is an issue about the borrowing powers or how things work financially, they need to get together. You can write anything you like to try to make mechanisms stronger, but people have to want them to work. Collaboration is as important as what is written in the bill.

However, the general principle is correct; those are significant issues for Scotland and, if we are talking about strengthening Scotland’s future, they have to be resolved and the scrutiny committee must be comfortable that there is a right way forward.

Robert Brown: Is there an issue with the development of the principles? I have the idea that there are golden rules, if you like, that surround the question of how much we could borrow, how far that could go before it interfered with the UK’s macroeconomic role, and how we would deal with issues that could be detrimental to the Scottish budget and ones that are not. Obviously there are lots of judgments to be made Do you think—having heard the earlier witnesses—that there is scope for development of the principles that have to be applied?

Professor Calman: There might be, and I will let Iain McMillan pick up on that. The only other seemingly relevant point in the earlier discussion was that many financial issues are about changing the governance of Scotland and how it operates. That is the bit that matters. What is the policy going to be? Finance will support the policy, but if you do not have the right policies, the governance of Scotland will not change. Sometimes we need to consider policy development as much as the way in which the money flows.

Iain McMillan: That is absolutely right. When I read the command paper, I got the sense that there is a genuine will to be collegiate about resolving disputes and differences. Indeed, the command paper mentions a taxation committee of UK Government ministers and Scottish Government ministers getting together and resolving all sorts of issues, such as changes to the tax base, which is an obvious issue that was discussed during the earlier part of the meeting.

It would be nice if all disagreements and disputes could be resolved in that way, but I suspect that, in the real world, it will be rather different. When serious disputes arise and cannot be resolved in that way, the public will hear the argument and will, at some point in the future, put their crosses in a box during a ballot. Healing and collegiate behaviour is best, but it will not always work.

Brian Adam: In his opening remarks, Sir Kenneth referred to Mr McMillan being the director of the CBI. For the sake of clarity, Mr McMillan, can you confirm that you were on the Calman commission in a personal capacity, and that you are appearing today in a personal capacity as a former member of the commission rather than as a director of the CBI?

Iain McMillan: That is absolutely right. I was on the commission as an individual, and I am here with Sir Kenneth in my capacity as a commission member.

16:30

Brian Adam: That is on the record. There is now no confusion.

I want to talk to you about things that you did not recommend, such as devolution of corporation tax. There has been a lot of debate on the subject, including in the committee’s deliberations, some of which you heard today. In terms of boosting economic growth, would cutting corporation tax not help? Why should it not be devolved to Scotland?

Professor Calman: I will make a brief response before I ask Iain McMillan to comment. You put the question to the previous panel: Anton Muscatelli's response was pretty straightforward. It was the response that we got as we discussed it in the commission. We decided not to recommend devolving corporation tax at that point.

Iain McMillan: We looked at our terms of reference and the evidence that came before us. The commission tried to strike the right balance between improving the financial accountability of the Scottish Parliament and Scottish Government and ensuring that arrangements are in place to continue stability. We looked at the balance between a degree of tax devolution and continuation of the block grant—a grant that would be reduced to offset the new devolved tax revenues. We weighed up those two and then looked at the suitability of other taxes as candidates for devolution. In that regard, we were much influenced by the advice of the expert group and the evidence that came before us. We feel that the recommendations that we arrived at strike that balance. Indeed, that was not only Ken's and my view, but that of all the commissioners.

Brian Adam: The fact is that long-term-trend growth for the UK is around 3 per cent whereas in Scotland it is 1.8 per cent. I know that we are in a bad situation, but the differential means that the gap widens all the time. Why should we not look at things that would encourage businesses to locate to Scotland, thereby encouraging growth? Is it not true that a number of Scotland's leading businessmen have called for exactly that? I refer to the likes of Jim McColl, Tom Hunter, Tom Farmer, Peter Burt and even David Watt of the Institute of Directors.

Iain McMillan: I do not recall those individuals giving evidence to the commission. We went by the evidence that was put before us and the advice of the expert group. In their evidence earlier this afternoon, Anton Muscatelli and others explained the volatility of corporation tax receipts. Commissioners were alive to the issue: we took advice in that regard.

Pretty well all taxes react to periods of economic activity—periods in which activity goes up and down. Professor Iain McLean made that point in evidence to the committee the other day. During a period of recession and low economic growth, not only income tax receipts but other receipts are affected. We wanted to get right the balance between retention of the block grant and further tax devolution to improve accountability.

Brian Adam: Do you not accept that sustainable economic growth will be one of the main things in making Scotland a better place? If corporation tax is not devolved, what other instruments should be available to the Scottish Government to influence growth?

Iain McMillan: One strong piece of evidence that we heard was on the importance of the economic union and the social union. Our recommendations have a fair bit of regard for that, too. As Anton Muscatelli and others explained earlier, the link between devolved taxation and economic growth is highly controversial. Although there may be a link in overall expenditure terms, my sense is that there is no evidence that increasing the tax powers of the Parliament would result in that. Certainly, that is my sense from today's evidence. François Vaillancourt gave evidence to us about that in the course of the Calman commission, and he said then what he has said today: we do not know the answer. In our view, the evidence was not strong on the matter.

Brian Adam: Are you suggesting, in that case, that it was not one of the aims of the commission to devise a system to improve Scotland's wealth?

Professor Calman: That is a really strange question. Of course there are issues around improving Scotland's economic mechanisms to make it a better place and to give it better economic growth. The question that you have focused on is whether corporation tax will do that. The answer that I have got from today is that it would probably not, and that there are downsides to that approach.

There are a whole lot of other things to take into account—that is the point that I think François Vaillancourt made today. If you change the financial levers, that in itself will not change anything; what you really need is to have in place the right policies. I can think of a number of policies that would change economic growth in Scotland that are not about changing corporation tax. That is a political argument—the bit for which the Scottish Parliament has much greater responsibility. How can we change Scotland's economic climate? Sometimes it is about the financial side of things, but that is not the only issue.

Brian Adam: Are you suggesting that, in order to stimulate economic growth, we do not require any further powers?

Professor Calman: I do not think that I said that at all, and you know that I did not say that. That is a complete misinterpretation of what I have just said. It is actually quite funny.

Brian Adam: If I have misrepresented you, I apologise.

Professor Calman: That is fine. Good. I can at least laugh about it—and I will not complain.

Brian Adam: I will phrase it in a different way. What powers, that they do not have currently, do you believe the Scottish Parliament and the Scottish Government require in order to influence growth?

Professor Calman: There is a great deal within the remit of the Scottish Parliament that could already do that, including in education and on the legal side. There is a lot that you can do now. You can change a lot of policies without any influence from Westminster. The Scotland Bill would allow you some additional financial ways to do that. We felt, having discussed the matter, that devolving corporation tax was not appropriate at this time.

Peter Peacock: I wish to pursue the matter slightly further. The businesspeople to whom Brian Adam has alluded might be in favour of such a move while Scotland was at the bottom end in relation to corporation tax, until Wales, Ireland or Northern Ireland undercut the rate. There would be a different view then.

You have summarised the evidence that we heard earlier today effectively. However, we have also heard today that, on occasion, if the regional economy is lagging behind that of the UK, there might be a case for using some limited discretion over corporation tax as an economic development tool. Instead of getting £200 million-worth of objective 1 money, a relaxation of regional selective assistance or whatever, another instrument might be to offer a bit of flexibility on corporation tax. You have indicated your view on corporation tax as a whole, but would such an approach potentially be one of the refinements to emerge from this process of scrutiny?

Iain McMillan: I am not sure about that. The idea of some kind of corporation tax credit was discussed earlier, although the conversation was not developed further. I am not sure that it would work.

Devolving corporation tax into subnational areas does not come cheap. Companies have to keep separate accounts of taxable profits. There is an issue about taking the maximum profit in the lowest-tax jurisdiction, to which Anton Muscatelli alluded in his evidence to us. There is certainly a cost to it. One would need to be very sure that those costs could be more than offset in order for it to work. There is a risk of a chase to the bottom.

Devolving powers is a bit like giving somebody a puppy for Christmas. They are not just for Christmas; they are for a very long time. Therefore, we must be sure that we get it right.

Sir Kenneth is right; he referred to some other powers of the Scottish Parliament. For a subnational legislature, the Scottish Parliament has considerable powers over investing in the supply side of the economy. It has had them since 1999, and that is a good thing. The Parliament also has power over the business rate—it could reduce it or even abolish it—but I do not hear any proposals for that. I would prefer to see some credible policy for using the powers that the Parliament has rather than the chasing of something that is not there.

I fully accept that there are those in our political life in Scotland who want greater self-determination as a political objective. I respect that, but at the end of the day there are powers that can be used already. I have not heard any of the gentlemen whom Brian Adam referred to speak about using the business rate to lower the cost of business and attract corporates into Scotland. That is strange.

Professor Calman: I want to make one other point. It is striking that many of the options that Mr Adam has raised and which have been discussed today could actually be pursued. That is not the issue; the issue relates to the risk and how far the risk goes. If you are prepared to take a big risk, you can change things. If you are not prepared to take a big risk, particularly in the short term, to make sure everything works, you probably will not do anything. The changes could be made—that is not the issue. The issue is how big you want the risk to be and whether you are prepared to manage the risk if things go wrong.

Peter Peacock: That is helpful; I am grateful for your answers.

I want to move on to a different and, in many respects, smaller issue. Some of your recommendations covered the question of re-reserving things. That seems to be odd to some people—in a process of apparently greater devolution, why would some things go back to Westminster? I do not think that you mentioned Antarctica—because, like us, you did not know that we had responsibility for it.

Professor Calman: I was pleased about that. [*Laughter*.]

Peter Peacock: Indeed—I think we share that view.

Another issue was the registration of certain medical professionals. Will you say a word about the principle of re-reserving, perhaps using that issue as an illustration?

Professor Calman: In one sense, that was a technical issue. When the original Scotland Bill was drawn up, there was a fixed number of health-related professionals, and registration for all of them was reserved. That seemed appropriate. Since the first bill was passed, a number of new professional groups have popped up, and currently there are two jurisdictions in which they are registered. It seemed to be complicated that professional groups who are likely to move from one place to another have to re-register one way or another. I think that I am right in saying that teachers are already quite separate in Scotland and England, which makes for some complications. The commission's recommendations were an opportunity to tidy up the situation. If the professional groups had all existed in 1998, they would have all been included.

Brian Adam: Can you tell us whether there was any request from the professional groups who are affected to have them included, or did the request come from other groups? For example, did you get a request from the dental technicians, which is one group that is affected, that you should consider reserving their registration?

Professor Calman: I would have to look back at the details. If I remember rightly, the issue came up early on because people were generally concerned. It came up from other professional groups, too.

Brian Adam: I have some concern that the recommendation came from a professional group that is not affected, but we have not heard from the professional group that is affected.

Professor Calman: You would have to tell me who you think that is.

Brian Adam: We hope to hear from the professional group that is affected, and it may be that there is merit in the argument, but it would have been appropriate to hear from that group.

Professor Calman: We can look back and double-check that point, but all I can say in response now is that the issue came out early on and has been in all the publications that we have presented. There have been no negative responses from the professional groups—unless you know something that I do not.

Brian Adam: No, I do not, but I would have heard directly from the professional group concerned.

16:45

Professor Calman: I was slightly surprised by your question, because we made the recommendation public and people know about it, because it seems to be entirely reasonable that professional groups such as dental technicians should be able to move from one part of the country to the other, and because there has been no aggro at all in relation to the issue. However, we will check to see where the concern came from. It came up quite early on—

Brian Adam: I understand that it came from evidence from some of the royal colleges. In other words, it came from some doctors, although it would affect not doctors but new groups, such as dental technicians. As I understand it, dental technicians did not contribute to the debate. We want to ensure that they have the chance to do so at this stage.

Professor Calman: They had every right to be part of the debate and I see no problem with their—

Brian Adam: I am not suggesting that you denied them the opportunity—

Professor Calman: We would not do that—

Brian Adam: I am just saying that you did not hear from them.

Professor Calman: We made all our recommendations as public as we could do and we have had no concerns back—unless you can tell me something.

The Convener: I think that we have aired most of the issues that we wanted to discuss. As always, the witnesses are welcome to write to us with follow-up evidence or to clarify matters. Are there further issues that members want to raise?

Tricia Marwick: I want to ask whether, given the importance of infrastructure investment in Scotland to economic growth, the witnesses are satisfied with the capital borrowing provisions in the Scotland Bill.

Iain McMillan: We did not put a figure on capital borrowing. We made two recommendations in respect of borrowing. First, we suggested that the existing short-term borrowing facility of £500 million be kept under review. Secondly, we thought that it was reasonable that the devolved Government and its legislature should have powers to borrow. It was put to us that, given that local authorities can borrow, it is strange that the Parliament cannot do so. We were persuaded by the evidence to make the recommendation.

As I said, we did not put a figure on capital borrowing. We are reasonably relaxed about that. If the evidence that the committee hears from the economists and so on is that the borrowing power should be greater, I do not think that Sir Kenneth and I would have any issue with that, provided that borrowing is at a sensible level and repayments are affordable. Of course, we cannot speak for our co-commissioners, because the role of commissioner no longer exists.

Tricia Marwick: There is concern, given that during the next four years there will be a 36 per cent cut in the capital budget, that the capital borrowing power will not kick in until 2015. The £2.2 billion cost of the replacement Forth road bridge will probably use up all the capital borrowing that is available to the Scottish

Government for the next 10 years, which will limit the number of other infrastructure projects that can be developed. In the circumstances, and particularly in the light of the Forth bridge's being the number 1 transport priority, would an upper limit be more acceptable?

Iain McMillan: I talked about the upper limit.

You mentioned the timing of the implementation of the provision. There might be a clue in that regard in the minds in the Treasury. The previous Westminster Government's white paper, which responded to the commission's proposals, went beyond Calman and tied capital borrowing to a tax decision. In other words, the previous Government was not prepared to allow borrowing without the Scottish Government's putting a tax resolution to the Scottish Parliament, to pay for the borrowing. The current Government has not imposed that condition, which Calman did not recommend. It might be that the Treasury is still linking borrowing to the introduction of the new income tax power. I see no reason why the Scottish Government and Parliament should not be given the borrowing power sooner.

The Convener: I am aware of the time—it has been a long afternoon. I thank the witnesses very much for their time and their evidence. I conclude the public part of the meeting.

16:50

Meeting continued in private until 18:12.

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