The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

SCOTLAND BILL COMMITTEE

Tuesday 13 September 2011

Session 4

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SCOTLAND BILL COMMITTEE
4th Meeting 2011, Session 4

CONVENER

*Linda Fabiani (East Kilbride) (SNP)

DEPUTY CONVENER

*James Kelly (Rutherglen) (Lab)

COMMITTEE MEMBERS

*Richard Baker (North East Scotland) (Lab)
*Nigel Don (Angus North and Mearns) (SNP)
*Adam Ingram (Carrick, Cumnock and Doon Valley) (SNP)
*Alison Johnstone (Lothian) (Green)
*John Mason (Glasgow Shettleston) (SNP)
*Stewart Maxwell (West Scotland) (SNP)
*Joan McAlpine (South Scotland) (SNP)
*David McLetchie (Lothian) (Con)
Willie Rennie (Mid Scotland and Fife) (LD)

*attended

THE FOLLOWING GAVE EVIDENCE:

Derek Allen (Institute of Chartered Accountants of Scotland)
Sir Kenneth Calman
Jim Cuthbert
Margaret Cuthbert
Professor Chris Heady (University of Kent)
Raymond Kelly (Chartered Institute of Taxation)

CLERK TO THE COMMITTEE

Stephen Imrie

LOCATION

Committee Room 2

Scottish Parliament

Scotland Bill Committee

Tuesday 13 September 2011

[The Convener *opened the meeting at 14:30*]

Decision on Taking Business in Private

The Convener (Linda Fabiani): Good afternoon everybody, and welcome to the fourth meeting of the new Scotland Bill Committee in the fourth session of the Scottish Parliament. I remind all present to turn off their mobile phones and BlackBerrys. We have received apologies from Willie Rennie.

The first item on the agenda is for the committee to decide whether to take in private item 4, which is the review of evidence that will be heard today, and to agree that all future such reviews be heard in private. Is that agreed?

Members *indicated agreement.*

Scotland Bill

14:31

The Convener: Agenda item 2 is the Scotland Bill. I welcome Sir Kenneth Calman of the Calman commission. I ask him to give us a few words of introduction before we move to questions.

Sir Kenneth Calman: Thank you very much. It is a pleasure to be here once again. The commission completed its work about two years ago. Since then, the Queen's speech has announced the Scotland Bill, which has now been published and has been through a variety of processes. It is now at the final stage and is going to the House of Lords and will, of course, come to this committee in relation to legislative consent.

As the commission has not met again, there are a lot of matters that I cannot say anything about because we did not consider them. However, I think that it would be very pleased with how things have progressed to this stage.

Stewart Maxwell (West Scotland) (SNP): Good afternoon, Sir Kenneth. I am interested in the remark that you made a few seconds ago that you think that the commission would be "very pleased" with how things have gone to this point. You may have watched or read the evidence from last week's committee meeting, at which I asked Michael Moore why the United Kingdom Government has taken forward approximately only 50 per cent of the original recommendations from your commission and had either rejected completely, ignored or watered down severely the other 50 per cent. What is your view of that particular outcome? Are you "very pleased" with it?

Sir Kenneth Calman: What I meant was that I do not think that we thought that the commission might have got as far as this. However, I think that everybody would be very pleased that it has. There are recommendations that have not been accepted, but that is what happens with commissions, so I am not unhappy with that.

Stewart Maxwell: So, which of the original recommendations have you changed your mind on? Do you believe that—

Sir Kenneth Calman: I have not changed my mind on any recommendations. It is entirely proper that the democratic process looked at our recommendations; if there have been changes, that is an entirely proper part of the process.

Stewart Maxwell: You do not have any views, in that case, on the fact that the UK Government has completely ignored—I will take the example that I used last week—the unanimous view of the Steel commission, your commission on Scottish devolution and the Scotland Bill Committee in the previous session that marine conservation should be devolved.

Sir Kenneth Calman: No. I have no views on that.

Stewart Maxwell: It seems to be rather odd that you do not have any views on an issue on which you obviously spent a considerable amount of time. You felt that—

Sir Kenneth Calman: The commission has no further views on—

Stewart Maxwell: Maybe I could finish the question.

Sir Kenneth Calman: I would be delighted.

Stewart Maxwell: You spent a lot of time on the matter. I presume that you took a lot of evidence on it and invested a lot of thought and effort. However, when your view and the unanimous view of many other people on the matter is completely rejected or ignored by the UK Government, you have no view on that. I find that surprising.

Sir Kenneth Calman: It is not surprising. I am here on behalf of the commission, which has not met to consider that question, so I cannot answer on behalf of the commission. That was a view that we put forward at the time. The UK Government has not accepted it. That is what happens in such things. I have no view on that.

Stewart Maxwell: I have no further questions.

James Kelly (Rutherglen) (Lab): Thank you for attending, Sir Kenneth. Will you comment on how the income tax proposals in the bill were developed and how they would give greater responsibility and accountability to the Parliament through tax-raising powers? What stability would they give to the Scottish budget and what ability would they provide to promote growth in the Scottish economy?

Sir Kenneth Calman: The key question is whether Scotland wants fiscal autonomy—partial or full. The move to that kind of autonomy, if it is to be made, carries risk but also has opportunities. Our proposals were based on two Administrations sharing a tax base, which works well in other places. A significant part of the process, which is set out in the bill, is that there would be a no-detriment principle.

Through the process, about 16 per cent of the £30 billion or so Scottish budget would have to be raised by the Scottish Parliament. The command paper that goes along with the bill makes it clear that the issue must be agreed between the two Parliaments in an open, equitable and transparent way. Tax receipts can go up or down, so there are always risks in such devolution. The proposals would give Scotland the beginnings of autonomy in raising funds for the Scottish Parliament and its budget for Scotland.

James Kelly: Will you expand on the no-detriment principle?

Sir Kenneth Calman: In "Strengthening Scotland's Future", the UK Government's paper on the bill, there is a series of points—on pages 22 to 26, if I remember rightly—on how the process will be managed. As far as I can see, it will be managed to ensure that during the transition period there is no detriment to the Scottish budget. As I say, tax receipts go up and down, and when that happens there must be a mechanism to ensure that that is levelled out until the final point when the final amount is removed from the block grant.

John Mason (Glasgow Shettleston) (SNP): I am glad to meet you, Sir Kenneth. I am completely new to the committee, so forgive me if I go over ground that has been gone over before. I have a couple of points on income tax. First, I believe that the commission suggested that the tax measures should include tax on income from savings and distributions as well as on earned income.

Sir Kenneth Calman: I do not think that we agreed that. That would be difficult to assess.

John Mason: There are practicalities about such tax being difficult to assess, but another challenge is that, if we have only part of those powers, small earners might move to incorporate.

Sir Kenneth Calman: I think that that is why we rejected the idea. I do not think that such a proposal was in the original commission report.

John Mason: If it was not in the report, I suppose that I am asking whether it should have been in it. I presume that, if there is a varying rate of income tax, it might be advantageous for some people to incorporate and therefore take dividends. If we do not have control over the dividends, does that create a problem?

Sir Kenneth Calman: I am not sure that I can answer the question. We thought that it was inappropriate to put savings accounts into the tax bit, so that issue did not figure.

John Mason: Right. Thank you

My second point is that, under the bill, the 10p variation would apply across all the rates, which I think was the commission's idea. This issue might have been considered previously but, by my thinking, a 1p increase would hit poorer taxpayers more than richer taxpayers, because it would be a higher percentage. Did you examine that and find it to be a problem?

Sir Kenneth Calman: Yes—that was one of the issues that we considered. The trouble is that, the more complicated the system is, the more complex it is to implement, which is why we left the proposal as it is. That issue could well be considered further. The issue of people on smaller incomes certainly arose.

John Mason: Did HM Revenue and Customs, for example, comment on the complexity of the system?

Sir Kenneth Calman: I do not think that it did so at the time. However, it seems to me that it is entirely appropriate to look at the issue at this stage in the process.

Joan McAlpine (South Scotland) (SNP): Thank you, Sir Kenneth, for coming along today. I want to ask about some of the commission's financial work. The expert group's first report, "Natural Resource Taxation and Scottish Devolution", which was authored by Professor Alex Kemp, who is the foremost expert on oil taxation, said that it would be a relatively simple matter to share the tax revenues from North Sea oil between the UK and Scotland, based on geographical share. However, when the commission's final report was published, it went back on that statement. What happened between Professor Kemp's writing the report and your recommending that no oil revenues be devolved?

Sir Kenneth Calman: It is relatively straightforward—[*Interruption*.] I am having occasional difficulty in hearing, for reasons that are—

Joan McAlpine: Shall I repeat my question?

Sir Kenneth Calman: No. I think I know roughly what you meant. I just hope that I understood you.

It is relatively straightforward to say that it is entirely possible to do something, which is what Professor Kemp said; the question is whether we should do something. In the discussions, the commission felt that it was not an appropriate thing to do, although it would be possible.

Joan McAlpine: In June 2010, Professor Kemp wrote a letter to *The Scotsman*, which appeared under the heading, "Share it out", in which he said:

"I favoured a scheme of sharing North Sea oil and gas revenues between the UK and Scottish governments".

Why did he feel the need to write to the newspaper to make that clear?

Sir Kenneth Calman: I have no idea. I did not read the letter. I remind you that the commission finished two years ago. I reread some of, but not all, the papers. I will do my best to answer questions, but I cannot necessarily answer them all.

Joan McAlpine: I understand that. I do not want to get down to too much detail. However, it is interesting that Professor Kemp, whom I think everyone agrees is the foremost expert on oil taxation—Professor Muscatelli said so in his foreword to the report—wanted a geographical share of oil revenues to be devolved. Something clearly happened in the commission's process to overturn Professor Kemp's view. He knew most about the subject, yet his views were discounted. Would you say that that was for political reasons, perhaps?

Sir Kenneth Calman: That is an entirely inappropriate statement to make. That is not the way the commission worked, at all. You ask for the reason why the view was overturned. We got the information through the commission's expert group, which Professor Muscatelli chaired. We recognised the approach but decided that it was not an appropriate way forward.

Joan McAlpine: Why did you decide that it was not an appropriate way forward?

Sir Kenneth Calman: That was because of all the other links around the oil issue. It would be entirely possible to do what was suggested, but we felt that it was not appropriate to do it, at that particular time.

Joan McAlpine: Why? I am sorry to press the point, but can you give the reasons in detail?

Sir Kenneth Calman: It is quite difficult to go back two and a bit years. If I had received some notice of some of your questions—including your question, Mr Maxwell—I could have answered them slightly better. I did not think that I was here to talk about the kind of detail that you are presenting me with. I apologise for that. If you want, I will go away and then answer the questions later. Without rereading everything, I cannot answer them all.

The Convener: I suggest that if committee members want to probe issues further, they let me know. Perhaps we can write to you and you can respond.

Sir Kenneth Calman: I would be delighted to do that. I would have to go back and reread all the marine stuff again. I was not sure that the issue would come up—it was not at the top of my agenda for today. I am doing my best to answer the questions.

On Joan McAlpine's question about sharing oil and gas revenues, we read what was said and we said that it would be possible, but we agreed why we did not want to do it. That is in the report.

Joan McAlpine: So, basically you do not know.

Sir Kenneth Calman: I do not know what?

Joan McAlpine: You do not know why the commission overturned Alex Kemp's advice.

Sir Kenneth Calman: I think I do know why. It is in the report and if you give me an hour I will read it and then come back and tell you. However, I cannot tell you off the top of my head. I am not going to give you the wrong answer. That would be quite inappropriate.

The Convener: That is fair. Sir Kenneth has said that he will come back to us in writing.

14:45

Sir Kenneth Calman: I will be delighted to do so. There is no problem about that, but I cannot answer some of the questions off the top of my head without thinking about them.

The Convener: I will come back to some of the generalities of the Calman commission. It is clear that the commission's report is the basis on which the previous Government's white paper and the Scotland Bill were formed.

The proposals that have caused most discussion are the income tax proposals. I remember noticing at the time—I have said it before and I say it again—that nowhere in any of the reports that were made to Calman by the independent group that Professor Muscatelli chaired could I find the proposal to devolve income tax and adjust the block grant along the lines of the proposal that ended up in the final Calman commission report. Can you explain how that happened?

Sir Kenneth Calman: Yes. The proposal came through some of our other experts, including Professor Vaillancourt from Canada. My memory is that it was part of the report and that the proposal was agreed with the expert group when we discussed the matter. I do not think that the proposal was not in it.

The Convener: I certainly could not find the proposal at the time. I will stand corrected if it can be found. I think that there has been dissent from some of those who served on the expert group as to whether the final proposal was what was discussed and agreed. Perhaps we can both look at that one.

Sir Kenneth Calman: The fact that an expert group discusses and agrees things that then come to the commission does not necessarily mean that we say yes to all the proposals.

The Convener: So, the full commission may decide to alter—I am sorry, perhaps that was the wrong word to use; please do not take offence—perhaps to consider the wider picture.

Sir Kenneth Calman: Absolutely.

The Convener: It may be that what the commission would report was not, in fact, what the expert group had come up with.

Sir Kenneth Calman: Yes. We either did not use or did not agree with a lot of the evidence that we received. Lots of evidence came in. The purpose was to take all the evidence that we could and come to a combined and agreed position to take us forward.

Alison Johnstone (Lothian) (Green): Thank you, Sir Kenneth, for joining us this afternoon.

Clause 18(2) of the Scotland Bill states:

> "One of the Commissioners shall be appointed as the Scottish Crown Estate Commissioner, who must be a person who knows about conditions in Scotland as they relate to the functions of the Commissioners."

It goes on to state that that commissioner

> "shall be appointed on the recommendation of the Chancellor of the Exchequer, who shall consult the Scottish Ministers before making that recommendation."

To what extent do you consider that that clause adequately addresses all the concerns that were raised by the Crown Estate review working group, the House of Commons Treasury Committee, the Scottish Affairs Committee's scrutiny of the bill in 2011 and this Parliament's Scotland Bill Committee in the previous session? How much opportunity did you have to investigate the issue fully? How much evidence were you able to take?

Sir Kenneth Calman: We took a bit of evidence but, as you suggest, a lot of evidence has been taken on the issue since then. That is where the commission was at the time.

One issue was that, occasionally, people did not give us the evidence until afterwards, when they realised that our report might lead to a bill and that something might happen as a result of the commission. We would have welcomed more evidence at the time. We thought that the appropriate way forward was to ensure that the commissioner had a proper Scottish locus when appointed and that the post was part of the Crown Estate commission. I have not followed the subsequent discussion in any detail. All I can say is that this is an opportunity for the committee and other bodies to look at the issue in more detail.

David McLetchie (Lothian) (Con): One task of the new Scotland Bill Committee is to examine proposals from the Scottish Government that would, in its view, strengthen the bill. You touched on some of the proposed changes in your answer to Ms Johnstone.

This is a huge question, but have you given some thought to the proposals that the Government has made since the election on corporation tax, excise duties on alcohol, the BBC, European Union involvement and so on, and do you have a view—admittedly, that would be a personal view, rather than the commission's view—on them? Can you tell us why some of those proposals were not in your original recommendations or why, in a sense, you rejected some of the propositions that are now being put to us?

Sir Kenneth Calman: All the issues that you raised are in the commission's report in some form or another, so they are not new. Am I right in saying that?

David McLetchie: I think so. The detail might be buried deep in the independent expert group's report on tax. If I remember correctly, the commission's report was relatively light on the subject of excise duties.

Sir Kenneth Calman: Yes, but all the other issues were covered. I do not think that the evidence that we got from the Scottish Government at the time covered any of those issues. I would have welcomed input from the Scottish Government on each of them at the time of the commission's report, rather than have you ask me about them now. When you ask me about them now, I have no response to give, because the commission's work is completed.

Some of the issues that were covered, such as airguns and speed limits, were raised by the Scottish Government. We picked up that evidence and put it through very quickly—we were very happy with that. On some of the other areas, I do not think that we got much information—not just from the Scottish Government but from other sources, which might have been helpful at the time. In the final report, we had to present the evidence that had come in.

All the areas that you mentioned—except perhaps the excise bit—are in the report. The time to influence it was two years ago.

David McLetchie: Yes, so the bus, or the boat, was missed in that regard at that time.

Sir Kenneth Calman: This is the opportunity to explore that, but I am not necessarily the person to ask, because we have completed our report.

David McLetchie: We will leave aside excise duties, which I do not think got a huge amount of consideration, simply because nobody thought it was a relevant subject for devolution at the time, as I recall. If I am correct, it was not discussed meaningfully in any way in the deliberations of the first Scotland Bill Committee, not because the committee members ignored it but because nobody raised it then, either. We will leave the issue aside, as it seems just to have been plucked from fresh air.

I think that there was considerable discussion about corporation tax in the expert group and in the commission itself. Can you share with us the reason why it was felt to be inappropriate to devolve responsibility for rate setting in relation to corporation tax, but appropriate to do so in relation to a revenue-sharing proposal for income tax?

Sir Kenneth Calman: Yes. If I remember correctly, the report itself makes it clear why we made those decisions. We discussed the corporation tax issue in detail. There is both a risk and an opportunity in introducing different rates of corporation tax across the UK, and in Scotland in particular. In our view, the risk was greater than the opportunity. Most of the evidence that we took was in favour of not changing corporation tax to make it a devolved function.

The excise bit is interesting, because—with an entirely different hat on—I have been very supportive of the Scottish Government's approach to alcohol, which I think has been very positive. The excise issue is a difficult one and it was not really covered in the report. There are downsides to what is being proposed, which may well be able to be handled in a different way. I have been very supportive of what the Scottish Government has proposed in relation to the problems of alcohol in Scotland.

David McLetchie: Yes, but that would not require the devolution of excise taxes.

Sir Kenneth Calman: That is correct.

Richard Baker (North East Scotland) (Lab): As David McLetchie said, we are reflecting primarily on the new request for additional powers that the Scottish Government has made. Interestingly, that request does not include the devolution of control of oil and gas revenues, so perhaps the Scottish Government is reflecting on the volatility of those revenues.

We are still focused on the income tax proposals. John Mason asked you about those proposals; as they stand, they will not enable the Scottish Government to set different rates for the higher and lower bands, so there will be no differential. I think that you mentioned that the primary reason for that was the potential complexity of such an arrangement. Was that the real problem, or was it to do with tax competition with the UK? Should we revisit the matter?

Sir Kenneth Calman: I do not think that it was to do with tax competition at all. The devolution of something like income tax is potentially a risky and complex business, although we felt that it was worth while. We are talking about taking a small step, which relates to 16 per cent of the budget. It will require quite a lot of collaboration between the two Governments to make the proposal work effectively. Making the system more complex at this stage in the process would create difficulty. That is not to say that things could not be done differently in the future, or that additional taxes could not be used. Our proposal was never seen as being the end of the process. It seemed to me that if we were to start the process of devolving control of the budget properly and to provide real accountability on raising taxes, what we proposed was an appropriate way forward, which is why we suggested it.

Richard Baker: So, the commission's default position was that the suggested changes were already substantial and that to introduce more complexity would have presented a higher risk now. However, that does not prevent us from doing more on those issues in the future.

Sir Kenneth Calman: That is why I said that the key issue is whether Scotland wants to be able to raise funds. If it does, we can move on from where we are now, which involves our getting a regular block grant. That is a risk-free mechanism, although it may not stay like that forever—things could change. If we wanted to take a very big risk, we would move to full fiscal autonomy. Selecting the income tax bands that we suggested would allow us to get the process started and see how things go. That would allow the process to be developed, from which things could be taken further.

Stewart Maxwell: I would like to finish off that point. You suggested that having full fiscal autonomy would be a very risky position for Scotland to be in. Is having full fiscal autonomy a very risky position for the UK to be in?

Sir Kenneth Calman: I think it is—you got that right. If devolving control of 16 per cent of the Scottish block grant is complex and has a risk associated with it, devolving control of 100 per cent of it must carry greater risk.

Stewart Maxwell: I do not follow the logic of that. I understand why it would be complex to devolve control of bits of things—that is complicated—but independent nations seem to do quite well managing 100 per cent of their fiscal policy.

David McLetchie: What nations?

Stewart Maxwell: I agree that the UK is doing very badly.

Moving on, I have a simple question on the income tax proposals. Why 10p? Why not 5p or 18p?

Sir Kenneth Calman: Three pence would be good. The figure of 10p was the one that we came up with. It is a figure that you can debate.

Stewart Maxwell: I am asking how you came up with it and what your reasons were for doing so.

Sir Kenneth Calman: It was a relatively straightforward figure to choose, as opposed to a figure of, say, 7.5p, and it gave a significant drop in the block grant, which the Scottish Parliament would have to meet. That is why we chose it. There was no magic formula that said that it had to be 10p.

15:00

Stewart Maxwell: I am trying to get the answer to why 10p rather than 12p or 15p was chosen. Is it fair to say that there is no deep and solid evidential reason for 10p as opposed to any other figure?

Sir Kenneth Calman: We were anxious to find a figure that would allow a reasonable amount of the Scottish block grant to be replaced by income tax, and 10p was a good figure to choose. I know of no evidential basis for saying that that is better than 11.5p.

Stewart Maxwell: You referred to "a reasonable amount". Who decided what a reasonable amount was?

Sir Kenneth Calman: The commission.

Stewart Maxwell: What were your grounds for deciding what a reasonable amount was?

Sir Kenneth Calman: I just tried to describe the grounds. The figure would give us a good reduction in the budget—16 per cent or thereabouts—which could be built on if doing so was appropriate. If all that is proposed works—I hope that it will and that Scotland will be able to raise its own taxes—the figure will provide a good start. The figure is reasonable. I know of no evidence base for saying that 11.5p or 4p would be better than 10p.

Stewart Maxwell: If I understand the proposal properly, cutting the block grant and replacing it with a 10p rate—if a Government chose that rate rather than 11p or 9p—should be revenue neutral and should have no impact on the Scottish budget. Is that the case?

Sir Kenneth Calman: That is correct.

Stewart Maxwell: Why would a Government choose that arrangement when—as Michael Moore explained last week—the Scottish Parliament would have to pay tens of millions of pounds to run the system that would allow us to replace the money from the block grant? Putting the income from a 10p rate back into the equation would not be revenue neutral, because we would have to pay tens of millions of pounds for the system.

Sir Kenneth Calman: I am not sure whether I accept that figure. I do not know what figure you are talking about and I do not recognise it.

Stewart Maxwell: The cost of running the system seems to be the subject of disagreement, but it would be quite expensive.

Sir Kenneth Calman: If I remember rightly, operating the Scottish variable rate of plus or minus 3 per cent would also have cost money, which was also in the budget. Is that not right?

Stewart Maxwell: Are you saying that 10p variability would cost no more or less than 3p variability?

Sir Kenneth Calman: That amount was in the budget. I do not know what figure you are talking about—I did not read Mr Moore's evidence. The system will have a cost, but I thought that HMRC would help the process by collecting the tax. A figure will be involved, but that also applied to the rate of plus or minus 3 per cent. If I remember rightly, the power to set that rate has lapsed.

Stewart Maxwell: If I remember rightly, HMRC failed to produce a system that worked. That was what happened.

Sir Kenneth Calman: The discussion is getting into the kind of area that is—

The Convener: We will stop the speculation, Mr Maxwell.

Stewart Maxwell: I will stop it if Mr Calman stops it.

The Convener: Do you have another question?

Stewart Maxwell: At the beginning, you said that one reason for the proposals was to increase the Scottish Parliament's financial responsibility. Is that correct?

Sir Kenneth Calman: That is correct.

Stewart Maxwell: What greater responsibility would the Scottish Government or Parliament have from a 10p variation as opposed to a 3p variation, which has never been used?

Sir Kenneth Calman: First, the figure is bigger—it is not small. If the management of it were not appropriate, it would be a significant figure to be playing with—we calculated that the amount would be about £5 billion. I think that the Treasury has probably sent the committee a paper that shows that the percentage would go from about 14 per cent to something like 20 per cent over time.

Therefore, the figure is a reasonable one. I believe strongly that Scotland is a country that could and should manage that area of its own affairs—I do not question that and the commission had no issue with that. The figure of 10p is an appropriate start in the process. If that were managed in the next few years to benefit Scotland and give Scotland a small amount of autonomy in managing its budget, that would be a big and important start to the process.

This is about what is best for Scotland, not what is best for the UK. I thought that our recommendation would give Scotland autonomy in an area on which it would then be able to build and develop.

Stewart Maxwell: I do not question at all your motives for doing what you have done, and I absolutely accept what you are saying. However, I am curious about the level of responsibility that the 10p tax will lead to. If a future Scottish Government increases the tax rate from 10p to 11p or 12p, it will, in my understanding, produce more revenue, but there will be no real effect on growing the Scottish economy. This particular financial lever seems to offer no incentive to grow the economy, because it will have virtually no effect on the Scottish Government budget. How much responsibility will the lever provide?

Sir Kenneth Calman: We have to consider the context. If Scotland grows, if employment develops and if new businesses come up, there will be more money in the system, more income tax and more money coming back into the economy. This mechanism is not the end point; a range of other mechanisms—about which you know more than I do—will raise employment and funding in Scotland, and that will then be reflected in income tax. If more people pay income tax, we get more revenue.

The Convener: In Jim Murphy's white paper or in Michael Moore's Scotland Bill, did the UK Government ask for evidence about where the figure of 10p came from—as opposed to 7.5p, 12p or 15p?

Sir Kenneth Calman: I cannot recall that happening. I am sorry that there is so much fuss about the figure; it came up as being reasonable and easily accessible. Most people know what 10p is; it is easier to measure and easier to calculate with than other figures. There is nothing magic about it.

Adam Ingram (Carrick, Cumnock and Doon Valley) (SNP): Good afternoon, Sir Kenneth. I will paraphrase my understanding of what you are saying: devolution is a process, not an event. You seem to be suggesting that the acquisition by this Parliament of more financial responsibility is a process rather than an event. The work of your commission kicked off the process, and we are now two years further down the line, so it is quite appropriate that we are considering building on what you have started. Is my interpretation correct?

Sir Kenneth Calman: I was just remembering that, when we launched the report in 2009, that was one of the points that I made. The report was an appropriate start to the process—a process that will take some time because it is complex and there is risk, as well as a huge opportunity. If the start is manageable and works well, then Scotland can have more autonomy.

Adam Ingram: As you are well aware, significant controversy remains over the West Lothian question, the block grant and the Barnett formula. I assume that your commission discussed those issues in detail and considered how the Scottish Government and Parliament could move away from relying on a handout from Westminster and could assume more responsibility for their own affairs. Things have moved on since then, but how much further can we go in addressing those particular issues?

Sir Kenneth Calman: The block grant is by far the simplest way of funding Scotland. I do not see it as a handout, as it happens; it is money that Scotland gives to the Treasury that comes back. “Handout” is not necessarily an appropriate term.

None of the people to whom I talk, particularly south of the border, likes the Barnett formula, because Scotland gets quite a good share of that funding. At some point, that will change. The commission’s discussions were partly about the fact that, if that changes, Scotland is likely to be worse off rather than better off. I cannot imagine a group of people saying that they would like to give Scotland more in the new Barnett formula, whatever that formula is.

For that reason, the more we can become self-sufficient the better. That is why the commission’s report suggested that the income tax powers were a way to start the process. It is not necessarily the end of the process. The less risky thing to do is to stick with the Barnett formula. Scotland does well out of that, but it will not do well out of it forever. Therefore, the bill provides an opportunity to begin to change.

Adam Ingram: Yes. We need to move down that line, otherwise a unilateral decision might be taken for us.

Sir Kenneth Calman: I am sure that it would not be a unilateral decision, but I cannot imagine that the decision would necessarily be positive for Scotland.

Adam Ingram: Thank you for that.

I presume that there was also discussion of the impact that your proposed tax-raising powers would have on the wider Scottish economy. Will you give us some flavour of your discussions? We have heard evidence that the proposals do not allow the Scottish Government enough access to levers to grow the economy on the one hand and, on the other hand, that the way the income tax powers are shaped might have a deflationary impact on the Scottish economy. To what extent were you engaged in wider discussion of the impact that the changes that you proposed would have on the Scottish economy as a whole?

Sir Kenneth Calman: We would not have made such recommendations had we not been aware of the potential consequences. The deflationary bias argument that has come into subsequent discussions is less relevant than the question of whether Scotland wants to look after its own economy. That is the really important question. Does it want to be able to raise its own funds and use them in developing a budget? That is what the income tax proposals were about.

The Scottish Government has many other economic levers. If they are used effectively, they will generate jobs, increase the number of people who are employed, increase their salaries and increase the tax base from which the Scottish Government’s budget can go up.

The debate is all within the fairly broad context of Scotland being able to function as a nation with the ability to raise funds and stand on its own feet.

Adam Ingram: That is a good note on which to finish.

The Convener: Joan McAlpine and John Mason wish to ask questions. I ask them to be fairly quick.

Joan McAlpine: I welcome the emphasis that Sir Kenneth Calman has placed on the fact that we are all here to enhance Scotland’s prospects and that what we are doing is all for the good of Scotland. He mentioned earlier that the solution that the Calman commission came up with was to take 15 per cent of the block grant and replace it with revenue-raising powers. He also talked about the block grant being a relatively good deal for Scotland. Does he agree that, because the block grant is a proportion of UK gross domestic product, it covers a basket of taxes?

Sir Kenneth Calman: Yes. That is the way that it is calculated.

Joan McAlpine: You propose replacing the basket of taxes with 15 per cent of one tax—income tax. However, a number of eminent economists whom we have had before us have explained that income tax grows more slowly than the basket of taxes. Therefore, in effect, you are replacing one mechanism out of which we do quite well with something that will be detrimental to us.

Sir Kenneth Calman: We also recommended that other taxes could be added—it was not just income tax.

Joan McAlpine: Yes, but those other taxes are relatively small and two of them have not been included in the bill.

15:15

Sir Kenneth Calman: I understand that, but which other taxes would you have added?

Joan McAlpine: All of them, obviously.

Did anyone point out to you that the consequence of taking the slow-growing income tax would be a shortfall in Scotland's budget over time? Even the Scotland Office accepts that, over 10 years, the shortfall in the budget would be about £691 million, although the Scottish Government says that it would be considerably more than that. However, there seems to be a consensus that, by devolving just one tax, we will lose money over time.

Sir Kenneth Calman: I am not getting into the details of that, because I have not seen the papers at all—my apologies for that. I cannot answer the question, although I know that the figures, which I have seen occasionally in the newspapers, are disputed. I cannot comment on them. You used a figure of £600 million and others have used £900 million. The figures come out of the air, I think. It is not as clear as you suggest that there will be a deflationary bias, that everything will go downwards and that Scotland will get worse. Why on earth would any commission want to do that?

The Convener: Or, indeed, any UK Government? We all have opinions about that. I am going to cut off Joan McAlpine there, because she could go on about that all afternoon.

John Mason: I want to touch on capital borrowing. I have a background in local government and I believe that the prudential borrowing scheme is fairly good. It has a lot of rules, regulations and guidance, rather than a fixed limit. Am I right in thinking that that was where the commission came from, too?

Sir Kenneth Calman: Yes. We felt that it is entirely appropriate that Scotland should be able to borrow appropriately. We considered prudential borrowing. The proposal in the bill is different, although again I have not looked at that in any detail. I think that the borrowing powers are greater than we suggested they should be, so the UK Government has gone further than the commission suggested, which I was relatively pleased about.

John Mason: They seem to be talking about a fixed amount, which is up for discussion.

Sir Kenneth Calman: Terms such as "they" and "us" do not help the process. Part of the process is about the two Governments working together to ensure that we get the right thing for Scotland. That comes through clearly in the bill. If that is the case, there will be an opportunity to consider the issue that you raise. As the process develops and as the Governments test how the form of autonomy through income tax and the borrowing powers work, there will be opportunities to discuss that.

John Mason: I take on board your points but, on borrowing, the commission was fairly strongly of the view that prudential borrowing was a robust model.

Sir Kenneth Calman: That was part of the discussion. I am just pleased that the UK Government increased the borrowing powers and included better cash reserves for the Scottish Government to ensure that, in the period of transition, which has to happen, opportunities are not lost to the Scottish Government and Parliament and the people of Scotland.

The Convener: I want to finish off on that point, but there is an issue that I want to clarify. If I remember rightly, the commission did not set an amount on the prudential capital borrowing.

Sir Kenneth Calman: I would have to look at that again.

The Convener: I think that that is the case. The previous Scotland Bill Committee asked for a limit of £5 billion, and the UK Government has since come up with a figure of £2.2 billion. How did you, as head of the commission, feel about that amount?

Sir Kenneth Calman: The principle is that Scotland needs to be able to borrow appropriately. There will be discussion between the two Governments to find out what that means. We felt that it was important to have the ability to borrow because there are big capital projects in Scotland that will enhance Scotland and make it a better place. We wanted to encourage discussions on the issue between the two Governments.

The Convener: The UK Government said that £2.2 billion in capital borrowing is a reasonable amount, but it did not produce any evidence base for that. We have heard from you that there was no evidence base for the 10p variation in income tax. Is that a sound basis for legislation?

Sir Kenneth Calman: I am struggling to think what kind of evidence you want. What evidence would I have given you that 10p is right and not 12p or 9p?

The Convener: It was not up to you to give that evidence; it is up to those who propose the legislation.

Sir Kenneth Calman: Yes, but we had a process over a period of a year in which we asked for evidence and information on all the issues. The commission's report is based on the evidence that we received. Clearly, judgment was involved in putting it together and we disagreed with some evidence and agreed with other parts. However, I am trying to think what the evidence would be to show that a figure of 10p is better than 12p or 9p.

The Convener: Or that a £2.2 billion borrowing limit is better than any other figure. Perhaps we should ask those questions of the UK Government.

Sir Kenneth Calman: You might do that.

The Convener: Thank you very much for attending.

Sir Kenneth Calman: Thank you. My apologies for not answering the question on marine conservation. If you had given me two minutes' warning, I could have answered it. I would have to read the papers. I am sure that we can answer that.

The Convener: Thank you for the offer to come back on that and for your attendance.

I will suspend the meeting while we change panel, although I am not sure that you can call a single person a panel.

15:21

Meeting suspended.

15:27

On resuming—

The Convener: I welcome our panel of witnesses, who are Professor Chris Heady, Derek Allen, Raymond Kelly, Margaret Cuthbert and Jim Cuthbert. Thank you very much for coming.

We have had a lot of written evidence from Jim Cuthbert and Margaret Cuthbert, and from Derek Allen and Raymond Kelly, so I ask for very short opening statements to set the frame for this discussion. As we have a large panel, could members be specific if they have questions for specific people on the evidence submitted? Witnesses need not feel obliged to answer every question. We will start with Jim Cuthbert.

Jim Cuthbert: Thank you very much for inviting us today. In our evidence, we concentrate on the effect of the income tax proposals and on the Crown Estate. I will say a few words on income tax, and Margaret Cuthbert will say some words on income tax and on the Crown Estate.

As regards income tax, we look at three aspects. First, on the mechanics of the Scotland Bill income tax system, our algebra indicates that the proposed system puts the Scottish Government in a position where it will have a greater incentive to raise tax than would either a Government of an independent Scotland or a UK Government facing the same shape of tax revenue curve.

Secondly, we look at evidence on the effect of fiscal drag. The figures suggest that, if a Scottish Government keeps a fixed tax rate—and its tax take is, indeed, likely to decline through time as a percentage of Scotland's income tax receipts—that not only increases fiscal pressure on a Scottish Government but reduces its stake in the success of the Scottish economy. For both those reasons, a Scottish Government operating under the Scotland Bill tax proposals, particularly in the tight fiscal climate that is going to be the norm over the foreseeable future, is likely to end up setting an income tax rate that is too high, with deflationary effects on the Scottish economy. In effect, what we are saying runs counter to what Sir Kenneth Calman just said. He said that the tax proposals are a small, safe, incremental step. We are saying that, if even that small step builds in perverse incentives, it could send us off in the wrong direction.

Thirdly, we look at the proposed transitional arrangements for tax and point out that they have severely perverse effects. In particular, a Scottish Government operating under those arrangements would always benefit from a further increase in the Scottish rate of tax no matter how much the Scottish economy might deflate as a result. For that reason, we strongly reject the recent suggestion that the transitional arrangements should continue indefinitely.

15:30

Margaret Cuthbert: Thank you for the invitation to discuss the Scotland Bill with the committee.

At the beginning of its deliberations, the Calman commission was asked to consider measures that would increase Scottish Parliament accountability, its financial responsibility and its responsibility for its actions in affecting the Scottish economy. It put forward its income tax proposals specifically to try to meet those objectives. It is our view therefore that, unless those aims of accountability, financial responsibility and assisting the Scottish economy are met, the proposals fall. Our evidence suggests that those aims are not met, so it would seem wrong to introduce the changes.

Further, if, as Professor Calman said today, the proposals are a means of starting a process towards greater autonomy, our evidence suggests that this is possibly a bad start.

On the subject of the Crown Estate, we have recently examined evidence of management in the Crown Estate that we think is a problem for Scotland in future. We would be happy to discuss that, too.

Raymond Kelly (Chartered Institute of Taxation): Thank you for the opportunity to attend the meeting. You said at the outset that I had submitted a number of written comments. I should say that those are not my comments but those of the Chartered Institute of Taxation. As you will be aware, the CIT is a non-political body representing tax advisers throughout the United Kingdom. Our principal concern therefore is not so much with the specific policy aspects of the Scotland Bill but with the practicalities of engaging with the proposals in the bill and any other proposals that may follow from it.

We have submitted written evidence indicating some concerns, particularly in relation to the definition of a Scottish taxpayer. Some people are excluded from being Scottish taxpayers even though it might appear that, in principle, they should be within the definition. There are also matters concerning the complexities of administering a tax that is broadly collected through the pay-as-you-earn system, through the obligations placed on employers.

I would be happy to expand on those comments.

The Convener: Thank you, Mr Kelly. I am sorry for daring to suggest that you agreed with your organisation's evidence.

Raymond Kelly: My personal views might not always coincide with the views of my organisation.

The Convener: Derek Allen will speak to evidence submitted by the Institute of Chartered Accountants of Scotland.

Derek Allen (Institute of Chartered Accountants of Scotland): I will say something similar to what Mr Kelly said. The Institute of Chartered Accountants of Scotland is non-political and our membership covers the spectrum of political activity. We accept the coalition Government's decision to bring forward the Scotland Bill and these proposals. Our interest is therefore to try to make the legislation work, with the minimum additional cost of compliance on business throughout Scotland and, indeed, throughout the UK.

As we said in our written submission, we are concerned that the right to tax depends on a sound foundation of understanding who is taxable. We are concerned that the definition of a Scottish taxpayer, built as it is on an unsound definition and practice historically of residence in the UK, is not the best way to do it.

As I understand it, there is no intention to use these proposals before 2016, so there is plenty of time to address the practicalities and ensure that the Administration can deliver what it is that Parliament and this Parliament decide, and at a minimum cost of compliance to the people in Scotland and the rest of the UK.

Professor Chris Heady (University of Kent): Thank you very much for inviting me. I am an economist who has worked a lot on tax. In fact, from 2000 to 2009 I was the head of the tax policy division in the Organisation for Economic Co-operation and Development, so some of my remarks relate to the experience that I gained from that work.

The main thing that I want to talk about is corporate tax, although I also have some views on excise duties, but not really on the other topics. The main point to make about corporate tax from an economist's point of view is that it is regarded as a rather poor tax to use as a subcentral tax, for three principal reasons. First, it would distort the allocation of investment between the parts of the country that had lower tax and those that had relatively higher taxes. That is an important point that comes up in reading the Scottish Government's proposal, which does not seem to be at all clear on whether the rest of the UK would lose revenue on account of it. It seems to me fairly clear that, if Scotland set a lower rate of corporate tax, some businesses that were going to invest in the rest of the UK would invest in Scotland, which would be good for Scotland, but it would cause the rest of the UK to lose revenue over and above any reduction in revenue that Scotland experienced itself. Rather the opposite is suggested in the paper from the Scottish Government.

The second reason is the risk of tax competition eroding revenue. That is similarly related: when you lower your tax, it hurts other parts of the United Kingdom and you do not face the full cost of that.

The third reason is revenue instability. Corporate tax is one of the most unstable tax revenue bases.

In fairness, I should say that, on the other hand, a number of OECD countries have subcentral corporate taxes. They recognise the disadvantages and they live with them for other, primarily political, reasons.

I also want to set out three practical considerations that are worth bearing in mind. One is that the corporate tax is a very complex tax; it is very much more complex than personal income tax. A large part of that complexity derives from the difficulty of splitting the tax base between the two or more jurisdictions in which a business might operate. That is much more difficult than deciding where somebody's residence is.

The second is that that means that there are additional compliance costs and it is possible—although I am not sure of this—that those costs could put off some English businesses that either have or are contemplating having a fairly small business presence in Scotland. Even though the rate would be lower, the compliance costs would be higher.

The third is that there has been a lot of comparison made with Ireland. I have to say—this has been said already, but I will repeat it—that Scotland is not like Ireland. There are two important differences that perhaps did not come out in previous discussions. One is that Ireland has an extremely special relationship with the United States, which is the principal source of its inbound foreign direct investment. Secondly, Ireland is in the euro zone—it is the only Anglophone country in the euro zone.

Overall, my view is that, as Sir Kenneth Calman said, it is perhaps better to use other ways than corporate tax to promote growth in Scotland.

The Convener: Thank you very much. I will open the meeting up to questions. The committee members all seem stunned.

David McLetchie: Professor Heady, I assume that you have looked at the Scottish Government's paper on corporation tax. Did you consider the modelling that was done to produce the benefits that would emerge—albeit in the relatively distant future of 2031—from a reduction in the corporation tax rate from 23 to 20 per cent? What did you think about that? When an economist does that kind of modelling, I presume that they make assumptions about constants—please correct me if I am wrong. If you are trying to identify the benefits of a policy measure, you have to assume that a whole lot of other things stay the same. For example, in relation to business, you might have to make assumptions about the exchange rate, what currency we have, what interest rates we are paying, and what employment law and regulatory systems we have. Is that correct? If so, what is your view on the value of such projections in the face of so many variables?

Professor Heady: Let me check that I have got your reference correct. Are you talking about the paper entitled "Corporation Tax: Discussion Paper—Options for Reform"?

David McLetchie: I am talking about the paper "Devolving Corporation Tax in the Scotland Bill", which was published in September 2011.

Professor Heady: That is the abbreviated version; the discussion paper is slightly longer.

David McLetchie: Yes. Box 2, "Initial Modelling Results from Reducing Corporation Tax in Scotland", is very helpful and gives a whole lot of benefits that it claims would arise from a reduction in corporation tax.

Professor Heady: Yes. You asked, first, what is my view of that. There is not a great deal of detail given on how the effects were obtained, but I am not surprised by what is shown. Certainly qualitatively, box 2 sets out the sorts of positive effects that I would expect to see.

Your second question was about the methodology and the assumption that all sorts of things are constant. That is a standard approach to use when we try to isolate the effect of a change. For example, we expect incomes generally and the size of the economy to grow over time, but sometimes it is not necessary to build that in to get an idea of the impact of a tax. We can ask what the impact would be if the economy were not growing—that would give us a fair basis for comparison.

Some of the literature that I have read on the subject—I cannot give an exact citation—lacks clarity in that respect. For example, people say, quite correctly, that there will be an increase in revenue from other taxes as a result of some of the given benefits, such as increased investment and employment. That will be a dynamic effect, which will grow over time. People then come up with a figure and say, "In 2020 or 2025, it will be this much," or, "In 2020 or 2025, the figure will have gone back to its previous level," and I do not know what the basis of that is. Is the model taking current pounds as a constant? Is it adjusted for inflation or for growth that would take place anyway? It seems to me that modelling on fairly fixed baseline assumptions makes it easier to identify exactly what the effect of a tax is and stops the process being conflated with a series of other processes that are going on.

David McLetchie: I think that I followed that.

The Convener: It would be useful to spend a wee while on corporation tax, rather than jump from one subject to another, so members should let me know if they want to ask Professor Heady something about that.

David McLetchie: I understand why modelling work proceeds on the basis that Professor Heady described. However, the model in the paper takes an isolated figure, based on one factor. It suggests that 27,000 jobs will be created in 20 years' time as a result of the reduction in tax, although many other factors could interfere with that. The likelihood of 27,000 jobs actually emerging over such a long timescale and all the other factors remaining constant must be next to nil.

15:45

Professor Heady: It is brave, shall we say. Economists are sometimes advised that they should not try to predict things, because they will always be wrong. You cannot take the 27,000 jobs figure literally; it is simply trying to give some idea of an order of magnitude.

I also agree slightly more broadly with your point that all of this depends on other things. Sometimes, the separating out that I mentioned has advantages and works quite well if the effect of those other things is somehow independent of the change in the corporate tax. However, after examining how investment has responded to changes in corporate tax in different countries, we know that certain things affect how large that response might be. Countries that have done very well have had, for example, very strong rule of law, very good infrastructure or a very highly educated workforce, all of which are among the other things that the Government of Scotland can influence. As a result, there are certain constant things that it would be important for you either to maintain or to move on in an even more positive direction in order to get a really good result.

David McLetchie: Thank you very much.

The Convener: I should say that the other witnesses will have the opportunity to respond to any issues that are raised and Professor Heady will also get the chance to talk about income tax, borrowing and bonds when we come to those issues.

John Mason: Although my questions are on corporation tax, they were suggested by points raised in Mr Kelly's paper. Am I allowed to ask him questions?

The Convener: Well, no. [*Laughter*.] Is it on corporation tax?

John Mason: Yes. An interesting point that emerged from the Chartered Institute of Taxation submission is that, aside from the headline rate, there are other issues around corporation tax. I would be interested to hear what any of the three taxation folk have to say on that matter. It is suggested, for example, that Scotland could have the power to target a particular sector, such as information technology, where we feel that we are weaker or stronger, but that would be more about using capital allowances than changing the overall tax take. Are the institute's members interested in such a move?

Raymond Kelly: As you will have seen from the submission, members looked at possible alternatives or additions to the devolution of the corporate tax rate. If you are seeking to influence specific types of behaviour—for example, to encourage capital investment or research and development—you can use the tax regime to do so. Indeed, for a number of years now, the UK has, like a number of other advanced economies, had tax reliefs for R and D, and our members thought that changes to that part of the tax regime might offer possibilities.

John Mason: Does Professor Heady wish to comment?

Professor Heady: Yes, I do. I got a bit anxious reading some of the Scottish Government's discussion points when it moved on to look at benefiting particular industries or activities. Given that most countries do this, one cannot be too critical about it. I would, however, make two points, the first of which is a very general one. The Government of Scotland has not outlined how it will split the tax base for—to keep it simple—a UK company between the bit that is taxed at the Scottish rate and the bit that is taxed at the rate in the rest of the UK. There are different ways of doing that, but it has not said which of them it would employ.

The easiest method is something that is called formulary apportionment. For that to work well, it is good if the base of the tax—the amount to which the rate is applied—is the same across the UK. It is not essential that there is a so-called common base, but it makes things much easier. If you were to start changing your base separately, that would make the whole thing more complicated and it might mean that you would have to adopt the alternative system of division, which is seriously more complicated. That is one area that you would have to be cautious about.

My second point is that, although there is fairly good evidence that capital allowances work, there is not very good evidence that R and D tax credits work—or, at least, that they provide good value for money. You could say that that is for the Scottish Parliament to decide and to take a risk on, but one of the problems with trying to encourage particular sorts of activities through the tax system is that the cost of doing so is not very transparent. If R and D subsidy were a line in the expenditure budget, people would look at it much more carefully than something that is lost in all the complexity of the tax revenues. It is a question of accountability, which is an important issue here.

John Mason: Yes. We will probably come on to accountability when we talk about some of the other taxes, particularly income tax, but, on corporation tax specifically, in tweaking the capital allowances or the rates, are we not in a sense just playing around with a very complex system? Would it not be better to give Scotland complete control over corporation tax and to have a very simple system here—one that is simpler than the UK's?

Raymond Kelly: There would still be the issue that Professor Heady has referred to, which is that most companies—certainly at the larger end of the corporate field—do not operate solely in Scotland. One of the points that have not been addressed in most of the submissions so far is how one ascertains what is a Scottish company and what is a Scottish corporate taxpayer, and how one deals with the assumption that, if a company is of any substance, it will do business in the UK and the rest of the world and not solely in Scotland. How one approaches that sort of split needs to be addressed.

John Mason: Was it your submission that referred to the existence of three types of company: those that operate entirely in Scotland, those that operate on a worldwide or Europe-wide basis, and those that operate across the UK? It is with the UK ones, not the others, that there is a problem.

Raymond Kelly: Yes. In practice, the UK ones are probably the most complex because they would have to do something new—they would have to split themselves up. I guess that the worldwide companies already have a UK/rest of the world split, but there would still be an internal UK split to be done.

John Mason: Right—thanks.

The Convener: I remind the committee—Mr Mason need not look so worried; I am not talking specifically to him—that we have a full session on corporation tax on 27 September.

A lot of members want to ask questions, but I am determined to finish the subject matter by 4 o'clock, so I ask members to decide whether they have a desperate need to ask their questions.

Alison Johnstone: I will direct my question at Derek Allen and Raymond Kelly, who both touched on concerns that cutting Scottish corporation tax would do more in the way of profit shifting than it would to create real economic activity. In appendix 1 of his submission, Mr Allen suggested that we might have to apply more anti-avoidance measures. Will you expand on the need to take a more holistic approach? Would that avoid the need for such measures?

Derek Allen: I do not think that it would. An earlier question was whether it was safe to assume a static background. My short answer would have been that it is absurd to assume a static background. In Europe, measures are being brought forward to introduce a common consolidated tax base for corporation tax. A number of jurisdictions in Europe are already lowering their tax rates and pushing corporation tax down. If we look at the logistics of corporation tax, small companies will be located, largely, where the proprietor of the business is located. The mobility is in the larger sector—the UK's small and medium-sized enterprise sector and the multinationals, which are, obviously, very large.

The worrying thing is that, in the complex commercial world that we now have, with so many valuable, intangible assets, there is an issue of transfer pricing: what do companies pay for the use of something? A concern is how much that pricing would add to the cost of complying with a corporation tax liability in the UK. In a split jurisdiction, we would need to introduce something that we do not need at present and which would not apply to the small and medium sector: an evidential trail to justify that, for example, what I sell this pen for is an arm's-length price. That will add considerably to the cost of compliance. The cost of compliance in the UK has been estimated in some instances to be as high as 8 per cent. Anything that adds to it is very unwelcome.

Does that answer your question?

Alison Johnstone: Yes, thank you.

Joan McAlpine: I would like to pick up Mr Allen's point about companies tending to fall where the proprietor of the business is based. Did you refer to medium-sized companies?

Derek Allen: Sorry?

Joan McAlpine: You made the point that companies are based in the same geographical area as the proprietor of the business.

Derek Allen: Yes.

Joan McAlpine: Given that so much economic activity is based in the south-east of the UK, do you not agree that the reason for proposing added stimulus for places such as Scotland and Northern Ireland is to counteract the effect of that? Business proprietors are all based in one area, where there is a critical mass of economic activity, so we need something to rebalance the situation.

Derek Allen: The situation in Northern Ireland is different from that in Scotland. Northern Ireland finds itself adjacent to southern Ireland, which has a 12.5 per cent corporate tax rate.

My comment about mobility is that a Government wanting to attract inward investment will want to attract the medium and large companies into the country because they will generate more jobs and, it hopes, greater economic prosperity. My remark about proprietors was really about micro-businesses, which will not move because of corporation tax. As a general rule, they are located wherever the proprietor of the business provides his services. If you want to incentivise and attract business and investment inwards, you should look at the medium-sized and large business sector.

Joan McAlpine: I do not think that it was in your paper, but Mr Kelly's paper states that the majority of large international businesses that were asked about this do not see a problem in the devolution of corporation tax. Why do you think that is? Why do you think that businessmen who operate in a large number of jurisdictions such as Mr Jim McColl and Mr Tom Hunter, who have companies all over the world, seem to be with the majority and do not have a problem in dealing with different rates of corporation tax in different areas where their businesses operate?

Derek Allen: I did not suggest that there would be a problem. Multinational companies deal with different rates of corporation tax all over the world. I suggested that there would be an additional cost within the company, because it would need to be able to demonstrate how much it pays for services supplied internally and for the use of intangible assets. That would have to be on an arm's-length basis; if not, we could end up with abuse and distortion.

The Convener: We have a last quick question on corporation tax from Mr Don.

Nigel Don (Angus North and Mearns) (SNP): I return to the helpful paper from the Association of Taxation Technicians and the Chartered Institute of Taxation, which refers to the question of deferred implementation of a cut in corporation tax. You point out that, if the cut is deferred sufficiently, businesses may not believe that it will ever happen. I am with you on that, but I wonder whether you could give me some clues as to what deferment means in this context. If the Government stated now that any company reporting in the tax year ending in 2013 would have a changed tax rate, that change would seem to me to be almost immediate in the context of company taxation. Will you give me some clues about what you meant by deferment?

16:00

Raymond Kelly: I do not think that I can give you any specific clues. The aim was to consider the possible effect on inward investment decisions, which take some time for people to make, if it was announced that something would happen in one year, two years or three years—the UK Government has already indicated its future tax rates for some time—and to consider the extent to which it would help to influence medium to long-term decisions.

Nigel Don: Am I right in thinking that businesses do not look to the long term?

Raymond Kelly: If a business was considering where to locate itself for some sort of new development, it would look to the reasonably long term. If we were talking about inward investment, the medium to long term would be the reasonable starting point.

The Convener: That was not bad, chaps: it was only 47 seconds over.

We move to questions on evidence that we have received on income tax, bonds and borrowing.

James Kelly: I address my points to Margaret and Jim Cuthbert. First, I thank them for coming along and giving us the benefit of their evidence.

There were three points to the Cuthberts' submission and Jim Cuthbert's opening statement, but is there a contradiction between a couple of those points? On the one hand, Margaret and Jim Cuthbert say that the way that the income tax proposals would work would provide an incentive for the Scottish Government to increase income tax. However, on the other hand, they submit that there would be fiscal drag because of the way that the tax yield would work. It seemed odd to me that they would feel that there would be an incentive to increase tax if that meant that the yield would not be as great.

In addition, what account would they take of the political and economic circumstances that would affect whether any tax rise was implemented? Let us not forget that, although we have tax-varying powers, they have never been used in the 12 years of devolution. There are political factors to be taken into account and economic factors to be modelled in.

Margaret Cuthbert: You mentioned that the tax-varying powers have not been used since they were introduced. That is not surprising because, when we look at the detail of those powers, we see that they are not to Scotland's advantage. We produced a paper on that in, I think, 1998, which showed that, if Scotland reduced its tax rate by up to 3p, provisions in the power would allow the Treasury to charge Scotland for the lack of tax revenues that were coming in. It is not really surprising that, when individual Governments consider the tax-varying powers, they have always said no at the end of the day.

That covers the political and economic circumstances, but our paper also suggests that the state of the economy and the state of the UK Exchequer as far as tax goes mean that, because of the peculiar mechanism that is proposed, the Scottish Government could end up operating differently from how it would need to proceed for the sake of the economy.

Jim Cuthbert: I did not quite catch the contradiction that James Kelly suggested on fiscal drag. The fiscal drag mechanism rolls on independently of anything that the Scottish Government might do.

As for your main question, which was on why a Scottish Government would increase a tax rate if that would damage the Scottish economy, that is precisely the point that we are trying to unpick in our algebra. As a Scottish Government increased its tax rate, it would get an increasing share of the overall tax cake that is collected in Scotland. Even if that cake were to go down, because the rate was increasing, the fact that you were getting a bigger share of a smaller cake would still make such a move worth while. As I say, we have tried to unpick that very mechanism in our algebra and what has emerged is that it is always more worth while for a Scottish Government operating under the Calman tax rules to increase its tax rate than it would be for, say, an independent Scottish Government facing exactly the same tax revenue curve. That is the heart of the distortion—the perverse incentive, as it were—to which we are pointing.

James Kelly: I could point out that the tax-varying powers were switched off before we got an opportunity to use them. Nevertheless, I submit that not using those powers acted as more of a political constraint on the political parties.

With regard to raising income tax and fiscal drag, you have said that there is an incentive in raising tax because one gets a greater share of the cake. How does fiscal drag relate to that?

Jim Cuthbert: Fiscal drag is actually a separate point that is best understood if we assume that the Scottish Government does not increase tax but instead operates a 10p Scottish tax rate. That 10p will take in half of the tax collected at the 20p rate, a quarter of the tax collected at the 40p tax band and a fifth of the tax collected at the 50p band. As a result, the Government will be getting a half, a quarter and a fifth of the three tax bands respectively. The fiscal drag argument suggests that because Governments tend not to index their tax thresholds fully, more and more tax will through time be collected from the higher tax bands—or the bands from which the Scottish Government is getting a lower share. As a result, the share that it gets of the overall Scottish tax take will tend to drop through time.

When we initially put forward that argument, Professor Muscatelli said that it would not work because, through time, Governments tend to adjust their tax bands to ensure that the share of income tax relative to GDP remains relatively constant. However, that is not a counterargument. Even if you adjusted your tax bands to ensure that that happened, it would not mean that the share collected from the highest tax bands would also remain relatively constant. You might well be getting a greater and greater proportion from the higher tax bands, in which case the yield of a Scottish 10p tax rate coming to the Scottish Government would tend to drop relative to the overall income tax that was coming in. That is what we observed when we examined the figures that the Secretary of State for Scotland submitted to the earlier Scotland Bill Committee and which estimated the yield of a Scottish 10p tax rate against total UK income tax receipts. When we expressed that as a percentage of Scottish tax receipts and removed the distortions caused by individual changes that happened in the first two years, we found a fairly consistent and significant drop from year to year in the yield of a Scottish 10p rate as a percentage of the overall Scottish tax take.

James Kelly: I still do not see the logic that under these proposals there is an incentive for a Scottish Administration to raise tax. After all, if, as you suggest, the yield from a 10p rate were to fall, surely the problem would be exacerbated by an 11p rate.

Jim Cuthbert: In a sense, it is just how the numbers fall out. Compared with the position of an independent Scottish Government or a UK Government facing the same shape of tax revenue curve, it would always be more worth while for a Government operating under Calman to increase tax. The algebra is set out in annex 1 to our evidence and I have to say that I cannot find any flaw in the logic set out there.

Margaret Cuthbert: Remember that the overall tax rate is staying at 20p, 40p and 50p, as set by the UK Government. What you are talking about is clearly a Scottish rate, which is increased within those rates, from 10p to 11p to 12p. The overall position in respect of how much tax is raised and what is happening to higher and lower rate taxpayers will not change. The increase is to the Scottish Government from raising the tax by 1p or 2p.

Joan McAlpine: My question is for Jim and Margaret Cuthbert, too. I am afraid that I am still going on about fiscal drag, convener.

I asked Sir Kenneth Calman about the consequences of replacing a basket of taxes, which are equivalent to GDP—the Barnett formula—with one tax, income tax, which grows more slowly. He did not agree with me on that, and he did not agree that we would be between £691 million and £8 billion worse off at the end of 10 years under that system. What are your thoughts on that?

Jim Cuthbert: I have tried to steer away from that area, because it has always seemed to be a slightly sterile argument. At times, income tax receipts drop relative to public expenditure, as has been the case recently, in which case you are worse off if you get part of your revenue via income tax rather than in line with Barnett. At other times, the opposite could happen: public expenditure and what you get through Barnett could drop relative to a rebound in income tax receipts, in which case you would be better off if part of your revenue was tied to income tax. That seemed to be the nub of the argument. A lot of the debate seemed to be about such timing effects.

I do not know whether, in the long run, there will be a consistent effect, but much of the debate and many of the figures that have been bandied about seem to relate to accidents of timing. Looking back at the evidence that Professor Holtham gave to the Scotland Bill Committee in the previous session of Parliament, it is interesting that he thought that the Treasury was pushing the transitional arrangements in order to prevent the Scottish Government from benefiting from a rebound in income tax receipts at a time when public expenditure was being pushed back.

Timing questions are important, but it would be wrong to draw universal lessons from whether, at any point in time or in the near future, one would be better or worse off under one or other system.

Professor Heady: I am slightly puzzled by Joan McAlpine's assumption that personal income tax will fall as a share of Government revenue; in fact, it has stayed remarkably constant in OECD countries over the past 30 or 40 years. As Mr Cuthbert said, it has gone up and down a little bit, but there is not a strong trend. It is possible that, in the future, there will be some switch, but if the Scottish Parliament has control over part of the income tax rate and the UK Government decides to lower its UK rate, it is open to the Scottish Parliament to increase the figure from 10 per cent, or whatever figure it has chosen, to offset that and thereby maintain the income tax take that it wants to obtain.

Joan McAlpine: Another concern that has been raised is the fact that we are depending on the Office for Budget Responsibility, which uses Treasury models to estimate our tax in three years' time. There is quite a lot of concern that that will result in a shortfall. I could not help smiling when you said that economists should not predict things, because they get them wrong. Is it wise for us to leave our future in the hands of a prediction by the OBR?

16:15

Professor Heady: I do not know which model the OBR is using. My understanding of its position is that it will exercise its own judgment about which model it will use, but I do not know how it has done that.

Joan McAlpine: It uses Treasury models.

Professor Heady: Okay. It would seem to me appropriate that, if the Scottish Parliament makes decisions that are based on the OBR's forecast, it should be allowed to question the OBR. As far as I understand it, the OBR makes its choices independently and cannot be directed by the UK Government to use particular methods. However, it would seem to me sensible that you would be able to question that judgment in much the same way as the UK Parliament can.

Joan McAlpine: There have been suggestions that the Scottish Government's capacity for economic predictions needs to be built up so that we could offer an alternative. Are you saying that that is a sensible idea?

Professor Heady: That is not what I was saying. However, it is good to have diversity in forecasts, so it would seem to me fairly sensible to have a beneficial exchange of views between two or three different forecasters because that would give a better outcome than from any one of them. I still stick to the point, though, that I do not think that the OBR is in any way biased towards the interests of one particular part of the UK rather than another.

Joan McAlpine: What do you think about the accuracy of its predictions?

The Convener: Margaret Cuthbert wants to come in on some of this stuff. She is getting impatient just sitting there.

Margaret Cuthbert: I want to return to Joan McAlpine's first point, which was about looking at income tax as opposed to a whole basket of taxes. That relates to one of the fundamental problems that we have found in fiscal change. As far as we are concerned, the Calman commission missed a trick in thinking of changing only one specific tax, without looking at the whole fiscal range, and handing it over to the Scottish Parliament. Many other things that are within Government control—such as regulation, competition and policy—affect the take that one gets from taxation, or affect how the economy grows. Nothing is said in the Scotland Bill on those items, but they are all very relevant to how tax will perform in Scotland. By looking only at corporation tax or income tax in isolation, we are forgetting that the levers of the other factors that are controlled by Westminster can very much affect the return that we will get and how the various tax matters are implemented.

The Convener: Joan, do you want to finish your point on the OBR, or are you content with where you got with that?

Joan McAlpine: I was about to ask Professor Heady what he thought of the OBR's accuracy in predicting future tax receipts. It had to revise its predictions on UK growth recently, did it not?

Professor Heady: Yes. That shows the danger of economic forecasting. However, the OBR is not the only body to have changed its forecast in that regard. The International Monetary Fund, the OECD and other major forecasters have lowered their forecasts for GDP growth, and that comes through in tax revenues as well. I am not an expert in forecasting—if I were, I would probably do it myself. However, I am not aware that the OBR is any worse than others in forecasting. We are in a time when it is extremely difficult to predict what will happen.

Joan McAlpine: Thank you very much.

Richard Baker: My questions are for Jim and Margaret Cuthbert. I take your point that there should be a wider debate on the interrelationships among the various taxes. However, we are where we are—not only in relation to the proposals in the Scotland Bill from the Government, but in relation to the specific proposals made by the Scottish Government on further tax powers that it wishes to discuss.

Income tax is a focus of this debate. You have said that the Scotland Bill proposals offer an incentive to the Scottish Government to increase taxes and that that could prove damaging. However, that is surely ascribing narrow motives to a Scottish Government—which I, for one, would never do. Surely a Scottish Government will always consider the issues more broadly; it will consider not only its own revenues from the taxation system, but the broader impact on the Scottish economy. Are you not being pessimistic?

Margaret Cuthbert: The word “incentive” was not used in this sense: I am passing a sweetie shop, the window is open, a big jar of toffees is sitting there, so I will steal it. The word “incentive” was not used to suggest that the Scottish Government would do that—by having the ability to raise a penny. However, at a time when major constraints are being placed on budgets, when people are expressing real concerns over standards in the national health service and education, for example, and when people are looking for public expenditure, the Scottish Government—like all other Governments—is considering how it can squeeze efficiency out of its public services while it is under quite a lot of pressure to increase tax.

Jim Cuthbert: Any sensible Government will consider the broader picture and take decisions to optimise things. It will also consider how much revenue it would get from a given increase in the tax rate. If that amount of revenue would increase, the Government’s decision would inevitably be affected to some extent.

I will give an analogy from the old days, involving local authorities, business rates and the resources element. The way in which the resources element worked was rather like the transitional arrangements in the Scotland Bill tax proposals. It meant that authorities that were below the resources threshold had an incentive to raise the business rate, even though doing so would push the local economy into decline. It was indeed found that authorities tended to raise the rate—because it benefited them financially to do so—and that places below the resources threshold were pushed further and further into economic decline. The situation that we are considering now is slightly different, but it contains the same sort of mechanism and perverse incentive. Obviously, Governments will consider the wider picture, but they have to consider the bottom line too. The balance will alter if the incentives alter.

Richard Baker: The local authority analogy is interesting. You quite rightly describe the pressures on the Scottish Government budget, but a five-year council tax freeze is in place, and there is a small business bonus scheme. The Scottish Government—wrongly on the issue of council tax—has decided that it will not raise income in those areas. Revenue could be increased, and that could relieve pressures in certain parts of the budget. I therefore question whether your analogy is appropriate.

Jim Cuthbert: The analogy was not with the current situation in local authorities; the analogy was with the old system of the resources element—

Richard Baker: The analogy is with the current situation in local authorities.

Jim Cuthbert: My analogy was that, when a perverse incentive is included, it will work through in a particular way.

Richard Baker: I am not quite sure that I follow the logic.

Margaret Cuthbert: You are the politicians, not us, and I appreciate that the factors that get you moving might well be different from ours.

Yes, politicians may act in particular ways when looking after their constituencies and the economy, but why include a mechanism, such as the one that we have been discussing, that will have the economic effect that we have described, when there are other ways of giving income tax authority to Scotland without offering perverse incentives? Why put those incentives on the table?

Richard Baker: You mentioned fiscal drag and the effect of the arrangements. The UK Government has made a commitment to no detriment—let us take that at face value—and the Scottish Government and the UK Government are to decide on a mechanism to ensure that the transition effects are neutral. Given that, are some of your predictions pre-emptive, if not pessimistic?

Jim Cuthbert: Hold on—I still struggle to understand what the no-detriment policy means. If it means that the system will be neutral when it is fully operational, that is one thing. However, if it means that the proposed transitional arrangements continue into the future, that builds in an extremely perverse incentive.

Another bit of algebra that we have done, which is not in the evidence that we gave the committee but which is referred to, shows that increasing the tax rate—no matter where it is—always benefits a Scottish Government under the transitional arrangements. If that is what no detriment means, it builds in an extremely perverse incentive.

That situation has been widely recognised. In their evidence to the previous Scotland Bill Committee, Professor Holtham and Professor Muscatelli rubbished the transitional arrangements and said that they should not be implemented in their proposed form.

We must be precise about what no detriment means. Under some interpretations, it could be very damaging.

David McLetchie: I was interested in Mr Cuthbert's response to Joan McAlpine's questions about the £691 million and £8 billion figures that are bandied about. You described the argument about comparing receipts with grants and so on as being sterile historically. However, the previous Scotland Bill Committee expended much time and effort on the question because the Scottish Government described the neutral position—the 10p position—as being indicative of an inherent deflationary bias.

I understand from what you said—you are welcome to clarify it—that you do not subscribe to the view that the neutral position creates an inherent deflationary bias. If I understand your papers correctly, you say

"that it is not possible to draw from"

something that Professor Midwinter said

"any general conclusion about whether the Scotland Bill tax proposals will be deflationary or not".

However, you say—it follows from your answers to Mr Baker—that the impact might be negative, depending on whether tax rates are increased in the future. You say that the neutral position is not inherently deflationary—is that correct?

Jim Cuthbert: No—that is not what I am saying. The neutral position is potentially inherently deflationary, because of the fiscal drag point. Two things are going on. One aspect is how overall income tax receipts vary through the economic cycle relative to the change in public expenditure and therefore what comes through the Barnett formula. The debate about the £690 million and so on is about that variation. We have not become involved in that debate, which is inherently sterile, as I said.

The other question is what the product of a Scottish 10p rate would do relative to overall Scottish income tax receipts. Through fiscal drag, that product would be likely to decline through time as a percentage of the overall Scottish income tax take. That element is not neutral through time.

Distinguishing those two elements is important. We have not examined the first point, which involves an inherently sterile argument. However, the second point could theoretically—and practically, given the figures that the secretary of state produced—be important.

David McLetchie: I am interested in how you go from describing something as being potentially inherently deflationary to saying that something will happen. That does not necessarily seem to flow. You refer to the fiscal drag effect, which assumes that fiscal drag will be a feature of national tax policy, whereas it might not be.

One of the first things that I remember in relation to dealing with the very problem of fiscal drag is the famous Rooker-Wise amendment to the Finance Bill way back in the late 1970s, which required the Government to index tax bands. That has been a feature of the UK income tax system since 1977, if I remember correctly. So, in fact, far from there being fiscal drag, the law of the land in relation to income tax in the UK basically says that there should not be fiscal drag. Indeed, at the moment, some of the tax bands are being increased at a considerably faster rate than the rate of inflation. So, I do not quite see how you get this inherent fiscal drag at all. You are making a policy assumption that is contradicted by at least some evidence of the past 30-odd years.

16:30

Jim Cuthbert: The general view is that the effect of fiscal drag is to increase through time the proportion of tax that comes from the higher rates.

David McLetchie: If there is fiscal drag.

Jim Cuthbert: Yes.

David McLetchie: That is exactly my point.

Jim Cuthbert: Sorry, but that is the general view. When we put forward this theoretical possibility, the response of Iain McLean and Anton Muscatelli was that Governments would so adjust tax thresholds that income tax receipts as a percentage of GDP would be kept relatively constant, but they did not consider whether, within that, the percentage coming from the highest tax bands would be relatively constant. The evidence of the figures produced by the secretary of state is that a fiscal drag effect can be seen coming through over the run of years for which the figures are analysed.

Margaret Cuthbert: I would like to say something precisely on that point. David McLetchie said that it has been Government policy since 1977 I think—

David McLetchie: Yes, since the Rooker-Wise amendment to the Finance Act 1977.

Margaret Cuthbert: You said that it has been Government policy since then that one should avoid fiscal drag. The figures presented by Michael Moore to the previous committee showed clearly that from 2001-02, the yield of a Scottish 10p rate as a percentage of Scottish income tax receipts fell from 41.7 per cent to 37.8 per cent. That shows that even where it is Government policy not to have fiscal drag, it still happens. What Scottish Parliament would go forward with a tax proposal where there is fiscal drag, despite the determined Government tax policy being that there will be no fiscal drag?

David McLetchie: Well, as you said yourself, a Scottish Parliament that wanted to raise more revenue in order to fund its spending programmes. The wider economic aspect might be negative, but a Scottish Parliament or Government that wanted to raise more tax revenue would do that—not that I would agree with that, but that is what it would do. Why would a Scottish Government not do it? It is a bit like the local authorities that you were talking about earlier. Of course they would want to do it if they wanted to raise another £400 million to spend on the health service.

Jim Cuthbert: We seem to be agreeing.

Margaret Cuthbert: But as far as the population is concerned, your constituents—

David McLetchie: No, sorry; with respect, you asked what Scottish Government would want to increase the tax. I am telling you: one that wanted to spend £400 million more on the health service.

Margaret Cuthbert: No. I asked what Scottish Parliament would want to introduce a particular tax proposal where the mechanism is such that fiscal drag will affect its ability to raise the type of tax that it wants.

David McLetchie: The answer is a Scottish Parliament that is working under the proposed system that wants to raise several hundred million pounds—which it would.

Jim Cuthbert: You are agreeing with us. You are saying that a Scottish Parliament would respond to the incentives built into the system in a particular way and the result would be—

David McLetchie: No, I am not. I am saying that certain politicians in the Scottish Parliament may wish to do that as part of their policy programme, which is their choice to put to the people.

Margaret Cuthbert: Well, maybe that is not a tax system that we would like to pass over to a Scottish Parliament.

Jim Cuthbert: The feature is a general one. We are talking about it as if it might be a new and unexpected consequence of the Calman legislation, but it is not new. An interesting feature of the Calman report is the extent to which it did not discuss the known features of tax-sharing regimes. An article by Chernick and Tennant that was recently published in the journal *Publius* states:

> “The more harmonized revenue systems are—i.e. the more the national and provincial/state level share the same tax bases—the greater the potential for competition between levels of government, and the greater the potential for overall rates of taxation to be inefficiently high.”

So getting inefficiently high rates of taxation in systems in which different levels of government share the same tax bases is a fairly standard feature that is well recognised in the literature. That is all that we are pointing out. In fact, we are pointing out that, in the Scottish position, it would be a bit more clear cut because, normally, in a federal system, states look over their shoulder at what other states are doing and a bit of inhibitory gaming goes on. That would not happen in the UK, because there is only the Scottish Government and there are no other states thinking of their tax levels. Therefore, what is liable to happen in the Scottish situation is more clear cut than the well-recognised feature in the literature that tax competition can lead to inefficiently high tax rates.

David McLetchie: The papers that the economists have presented demonstrate polite academic wars going on between you and others. It is only fair to say that those well-recognised features are not well recognised by many of the people who dissent from your propositions, otherwise there would not be any interest in writing articles for the *Scottish Left Review*, which is not a publication that I pick up at the dentist’s.

The Convener: I will interrupt you there, Mr McLetchie. It is clear, and all economists will say so—in fact we heard it earlier from Professor Chris Heady—that there will always be disagreement among those in the profession, just as there is among politicians. I do not think that we should bring that into our committee when we are trying to get information that will help to inform us on what is best for Scotland.

David McLetchie: Indeed we are.

The Convener: Mr Don has the next question.

Nigel Don: Thank you, convener. That gives me a nice introduction to my question, because I will continue with the economic argument among economists. I take on trust everything that they have written, although if I really want to get to sleep tonight I will look at the algebra. To what extent are the proposals recoverable? If we had the ability to change the 10p rate differentially across the bands or to change personal allowances—to mention but two issues—would that, given the mechanisms that we have, give us a get-out-of-jail card, or is the whole system irredeemable?

Margaret Cuthbert: No, it is not. One of the economists who gave evidence to the previous Scotland Bill Committee was Professor Vaillancourt who, as far as we can gather, was the one who came up with the specific scheme in the bill. It is correct that the report of the group of economists to the commission did not include that scheme at all. The idea was given by Professor Vaillancourt at a meeting. In fact, what he was talking about seems to have been based on a Canadian system, where there are several states, not just one. Under the original Canadian model, the central Government and the individual state operated a proportional split of each of the tax bands. So there was not a flat 10p coming out of the 20p, 40p and 50p bands. Instead, each took, say, 50 per cent of the first band, 50 per cent of the second and 50 per cent of the 50p band. That was how it operated.

Nigel Don: Forgive me for interrupting, but does that overcome the perverse incentives?

Jim Cuthbert: It overcomes some of the perverse incentives. In one of our earlier papers—I cannot remember whether it was in the *Scottish Left Review* or the Fraser of Allander institute's *Quarterly Economic Commentary*—we did the mathematics of how you could get over some of the major perverse incentives. Virtually the only approach is to do this business of having a fixed percentage take from each tax band.

However, we did not advocate that. We said that although it was an interesting mathematical curiosity and that you could get round the major perverse incentives by doing that, it opens up a whole new can of worms that means that the actions of one level of Government impose more directly on the actions of different levels of the Westminster Government. Therefore, you would have to operate the system with a considerable degree of co-operation between the different levels of Government. We said that there are avenues there to be explored if you want to get round those perverse incentives.

Nigel Don: I guess my question is, how do we fix this? Perhaps Professor Heady might want to come in on that.

Professor Heady: Okay. It seems to me that there are several perverse incentives. The first one that was discussed was the issue about the excessive incentive for the Scottish Parliament to raise its rate. That is a generally accepted principle when you have two Governments who levy a tax on the same base. If the Scottish Government increases its rate, and people maybe work a little bit less, the tax base goes down, which hits the rest of the UK as well as Scotland while, in the model, Scotland does not care about the rest of the UK. That is how it comes out.

There are countries in which that has been a problem. For example, the Danes have introduced a rule that limits sub-national governments' income taxing power to try to deal with that. You cannot get round that problem without making Scotland fully responsible for personal income tax in the same way as the Scottish Government is proposing that it should be fully responsible for corporation tax.

The other issue is the declining share of Scottish GDP that would come in personal tax if you stuck at, say, the 10 per cent rate. One way out of that is simply to keep on raising the Scottish rate. That would get you the extra revenue. The problem is that it would not have quite the same distributional impact as being able to choose the rates on the different bands, but it would maintain the simplicity.

The normal economic theory of how different parts of a federation should relate is that the centre should be responsible for redistribution and the sub-central governments should simply be concerned with revenue raising. Obviously, at least some members of this committee want the Scottish Parliament also to have some redistributional power. The simple way of saying, "Well, they're just revenue raisers", is the Nordic model, under which there is just a single rate, as is proposed here.

The redistributional model is more North American—it operates in Canada and the United States, for example, and also in Switzerland, where the cantons can have whatever income taxes they like.

The Convener: Mr Don, can you finish on this point?

Nigel Don: I take it to our tax advisers, then. Everyone sees the benefits of simplicity—I buy that as a general principle—but why is it so difficult to put two different rates into your software? Why can you not have different rates in Scotland for these bands? It is just an X, Y or Z in the algorithm, is it not?

Derek Allen: I am not an expert on software but I would have said that you are right. The existing programmes would allow flexibility for differing bands.

Nigel Don: If they do not, surely the writer should be sacked. If the allowances can be changed, why can the rates not be changed?

Raymond Kelly: I think that the complexity is not the rates per se—the rates are the rates, and in the past there have been many more rates in the United Kingdom than there are now. Although I am not a software writer either, one assumes that software can accommodate rates without that much difficulty. The difficulties lie in some of the more technical and definitional aspects, such as who is a Scottish taxpayer, how does one determine the income of a Scottish taxpayer and what happens if someone leaves Scotland during the year.

16:45

Nigel Don: Yes, but those are inherent to the base of the model, not to the numbers that go into the model.

Raymond Kelly: Yes.

The Convener: That leads me to two brief questions for Mr Allen and Mr Kelly.

When the Finance Committee in the previous session took evidence from HMRC about the Scottish variable rate and its potential implementation, the committee was shocked to learn the rate of efficiency that HMRC worked towards.

At our previous meeting, we heard that the Institute of Chartered Accountants of Scotland thought that the cost of implementation was going to be £150 million—that is on the record. However, the secretary of state has said that he reckons that it might cost only £45 million. Given that we know that the Scottish Government has to pay that—the money will come out of Scotland—do we now have a more accurate figure for how much implementation will cost, in your professional opinions?

Derek Allen: No, but, again, it is not set in tablets of stone. We have been urging that work to prepare for implementation to begin now.

In order to illustrate the position that we are in, I will contrast our situation with that of another jurisdiction.

Canada has a lot of incentives. Around 260 tax expenditures are available to Canadian citizens that allow them to claim for new housing, new fireplaces and so on. In their annual return, they are required to declare the state in which they are resident.

In the UK, we have a tax-paying population of approximately 30 million, of whom 8.5 million complete tax returns annually. The vast majority do not complete tax returns, which means that HMRC does not have a database that shows whether they reside in Scotland or elsewhere in the UK.

If we start now, we can find ways of solving the problem in as cheap a way as possible. We need to realise that this is a real problem. There is a tendency to say that the problem will involve only a few itinerant workers who cross over the border, but that would be extremely naive, given what we know about modern society. Workers go all over the world—historically, the Scottish population has been famous for going overseas as well as south of the border. The legislation that is being proposed demands day counts. Do people keep records of day counts?

If we are going to implement the proposals, we must start addressing the practicalities to ensure that the integrity of the tax system is protected. If the Scottish Government does not know who it has the right to tax, it will not be able to ascertain how much tax it is due.

The second point is that, if you end up with disputes, that will not be cheap, as the cost of an individual dispute can escalate—even going to the first-stage tribunal, where it might be that no costs are awarded, can often cost a great deal in time and money.

Getting the definition of a Scottish taxpayer crystal clear is an essential building block. To build on that, we need a definition of who is UK resident at the present time.

The Convener: Was work not being done on that in relation to the implementation of the Scottish variable rate?

Derek Allen: The Scottish variable rate has never been exercised.

The Convener: Exactly. It probably could not have been, even if we had wanted it to be, given the amount of time that that would take. However, that is a different debate, and one that we have already had.

Do you still stand by the figure of £150 million?

Derek Allen: It could be more. In fact, unless we address the problem and properly define the right to tax and therefore the right to the money, it could be an awful lot more. After all, the necessary register and database containing the details of where people are resident simply do not exist at the present time. Moreover, as far as the self-assessment regime is concerned, the fact is that ordinary people are not keeping the necessary records to determine where they are resident for the purposes of the bill.

The Convener: I believe that you said earlier that we had time to implement some of this stuff. However, 2016 is not all that far away, particularly when you consider how long the Parliament has been in existence and the fact that none of this work has been done. How confident are you that we can actually achieve this by 2016, given

HMRC's record with computer and IT applications?

Derek Allen: I wish that you had not asked me that question. [*Laughter*.] I do not want to take on the part of saying how confident we should be but I would have thought that, with a willingness to work towards this aim, it is certainly achievable.

The Convener: Thank you for that.

Raymond Kelly: I should point out that it is not purely a matter of HMRC's ability to achieve this or of IT systems. As Mr Allen said, much of the problem actually arises from the definition of a Scottish taxpayer. Ultimately, many people will not be clear whether they are a Scottish taxpayer until the end—or nearly the end—of the tax year as it applies to the itinerant worker population. If one has an obvious inherent uncertainty built into the system, one will have something that is inherently much more complex than that which currently exists. That will require additional record keeping by individuals, which in turn will incur additional costs from advisers—which some people around the table might see as a good thing—and require HMRC to undertake additional work, the cost of which is not easy to speculate on.

The Convener: Thank you very much for that.

At the start of the meeting, Mrs Cuthbert said that she wanted to raise some issues about the management of the Crown Estate. As Alison Johnstone has a particular interest in that matter, I will bring her in at this point.

Alison Johnstone: I thank Mr and Mrs Cuthbert for their submission on the Crown Estate. I was interested, in particular, to learn more about Crown Estate Commissioners' involvement in the ownership of the Fort Kinnaird shopping park. They appear to have taken on a significant amount of debt, even though, under the terms of the Crown Estate Act 1961, they are barred from borrowing. Surely if this type of joint venture or model of ownership involvement were to replicated in relation to, for example, the sea bed, it might have very serious consequences for the future.

Margaret Cuthbert: That was actually our reason for writing that article. When we investigated the Fort Kinnaird transaction, we discovered a tremendous lack of transparency along the way and found it very difficult to work out what was actually happening with financial flows. Moreover, although the Crown Estate's accounts clearly show that this is a long-term loan, the repayment of the notes is pretty short term. I cannot remember the exact date but I believe that the first date is potentially 2013.

Aside from the problem of transparency, it is also the case that, as you have rightly pointed out, the 1961 act stipulates that the Crown Estate cannot borrow. In the transaction with Hercules Unit Trust, it went through an intermediary to the Irish stock exchange and raised with Hercules Unit Trust a £200 million loan, of which £100 million is shown in its annual accounts.

The Treasury officials who allowed that to happen said that they had not passed the matter up to ministers. Therefore, it is possible for such things to go on without being taken higher up in the Treasury to get ministerial approval and, indeed, without the approval of the Secretary of State for Scotland. The 1961 act says that the Secretary of State for Scotland can intervene in such cases, but as far as we can see that has never happened.

Alison Johnstone: It is surprising that the secretary of state would not insist on being able to intervene or at the very least on being informed that such activity was going on. In your submission you described the Hercules Unit Trust as

"an unregulated collective investment scheme."

Margaret Cuthbert: That is because it is Jersey based. If you look on the British Land Company's website—British Land is one of the major owners of the Hercules Unit Trust—you will find all that explained in detail.

What worries us is the proposal in the Scotland Bill to appoint a Scottish Crown Estate commissioner. We are concerned that the 1961 act is not necessarily sympathique with what a Scottish Parliament might want of such commissioners, as you will see when you read it. The primary interest is to make a profit. In relation to a number of cases involving Scotland's coast, that might not be the primary interest of the people of Scotland.

The Convener: Mr Don has a question, which he promises will be very quick. I ask for quick answers, please.

Nigel Don: I am grateful, convener. Given that our witnesses are economists, I want to take the opportunity to go back to the proposals on capital borrowing. At last week's meeting I put it to the secretary of state that the proposals seem to be counterintuitive, because, as they stand, the larger our capital allowance in a year, the more we can borrow. I would have thought that the years when the capital allowance is relatively small would be the ones in which we will want to borrow—and vice versa. I think that the secretary of state said that he understood what I was saying but would not describe the issue in the same way. Have the witnesses considered the matter? Do you share my view that it seems to be counterintuitive? Is not the approach the wrong way round?

Jim Cuthbert: I have not looked at the issue.

Margaret Cuthbert: I read what you said and I agreed with you, but I have no expertise on the matter.

Nigel Don: I am grateful for your agreement. Professor Heady?

Professor Heady: I am afraid that that is not an aspect that I have looked at.

The Convener: Those were quick answers.

The committee agreed to consider welfare benefits and how they tie in, for example in the context of the Welfare Reform Bill. It struck me as I listened to the discussion about income tax that if there is a flat rate and no facility to vary the rate for higher-rate taxpayers, the approach would be regressive, because it would disproportionately hit people who pay tax at the lower rate. Is that correct?

17:00

Professor Heady: That is not how economists normally look at progressivity. We do not normally look at the share of the tax; we look at whether, for people on low incomes, the ratio of tax to income is lower or higher than it is for people on higher incomes. A progressive tax is one whereby richer people pay a higher proportion of their income.

If the flat-rate tax that you set—at 10 per cent or whatever—had no exemptions and started at zero pounds, the Scottish part of the tax would be proportional: it would be neither progressive nor regressive. In fact, under the proposals, people will have the same exemption as the rest of the United Kingdom, which I think will be about £10,000, or possibly more by the time that the powers come in. That means that it is progressive, because a higher proportion of the income of people on higher incomes will be subject to the tax. Only half the income of somebody who earns £20,000 will be subject to tax, whereas 90 per cent of the income of somebody who earns £100,000 will be subject to the tax, so that is a progressive system. It may not be as progressive as some committee members might like, and it is not as progressive as the overall UK personal income tax system, but I would not describe it as regressive.

The Convener: The person who was not earning much but was hit with it might describe it as regressive, but there you go. We will have to chew on that one. Who was it who said that economists never agree? I think that we have had evidence that suggests otherwise.

Professor Heady: Can I come back on your comment, convener? Somebody who is really poor does not pay anything.

The Convener: Surely poverty is relative.

Professor Heady: Yes. I agree that it is difficult for poor people to pay taxes—there is no question about that. Maybe it is just an issue of language and how we measure it, but somebody who earns £11,000 will not pay much in tax as a proportion of their income. That recognises to some extent the fact that it is harder for poor people to pay tax. The question of how much smaller a proportion of their income they should pay in order to balance their financial situation is a difficult one, and different people will make different judgments.

The Convener: Surely if you do not have the power to vary the rates of income tax, you cannot have any measures that try to balance out the situation and have a fairer society.

Professor Heady: That is right. I refer to a point that I made earlier: the standard view among economists who look at relationships across federations is that it is a responsibility of central Government—the UK Parliament in this case—to redistribute income through having higher rates of income tax on high earners and by having social benefits, and that redistribution is better conducted at the centre because there is at least the potential that if it is done in different localities, as happens in some other countries in Europe, migration happens so that the poorer people go to areas that are more redistributive and the richer people go to the areas that are less redistributive.

The Convener: We have finished where we started—there were the same arguments about corporation tax. This is an issue that we can raise at our meeting on benefits, as other economists clearly have an opposing view to yours, Professor Heady. There is another interesting session to come.

I draw this evidence session to a close. I thank everyone on the panel for attending; it is much appreciated. We will certainly pore over your evidence and give it due deliberation.

17:04

Meeting continued in private until 17:16.

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