The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

FINANCE COMMITTEE

Wednesday 7 May 2014

Session 4

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FINANCE COMMITTEE
14th Meeting 2014, Session 4

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*John Mason (Glasgow Shettleston) (SNP)

COMMITTEE MEMBERS

*Gavin Brown (Lothian) (Con)
*Malcolm Chisholm (Edinburgh Northern and Leith) (Lab)
*Jamie Hepburn (Cumbernauld and Kilsyth) (SNP)
*Michael McMahon (Uddingston and Bellshill) (Lab)
*Jean Urquhart (Highlands and Islands) (Ind)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Professor John Kay
Professor Gavin McCrone
Professor Peter McGregor (University of Strathclyde)
John Swinney (Cabinet Secretary for Finance, Employment and Sustainable Growth)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance Committee

Wednesday 7 May 2014

[The Convener *opened the meeting at 09:30*]

Scotland Act 2012

The Convener (Kenneth Gibson): Good morning and welcome to the 14th meeting in 2014 of the Finance Committee of the Scottish Parliament. I remind everyone present to turn off any electronic devices that they may have on their persons, please.

Our first item of business is evidence from the Cabinet Secretary for Finance, Employment and Sustainable Growth on the implementation of the Scotland Act 2012. Mr Swinney is accompanied by Alistair Brown and Alison Cumming of the Scottish Government.

Both the Scottish and United Kingdom Governments are required to produce reports under section 33 of the 2012 act. Members have copies of both reports. The committee will take evidence on the UK Government's report in the coming weeks.

I welcome our witnesses to the meeting and invite the cabinet secretary to make a short introductory statement.

The Cabinet Secretary for Finance, Employment and Sustainable Growth (John Swinney): Thank you, convener. This is the second annual report, and it is the last report before the devolved tax and borrowing provisions in the Scotland Act 2012 are implemented in April 2015. Our report describes the progress that continues to be made by the Scottish Government on the arrangements for implementing those provisions.

Significant work has been undertaken over the past year in line with the programme plans. The pieces of legislation for the land and buildings transaction tax and the Scottish landfill tax have completed their parliamentary stages and have received royal assent. As the committee has already been advised, I will announce rates and bands for the devolved taxes this autumn when I present the 2015-16 draft budget to Parliament. That is also in line with agreed changes to the written agreement on the budget process.

There continues to be good co-operation between Her Majesty's Revenue and Customs and the Scottish Government as the implementation project for the Scottish rate of income tax proceeds. The Scottish Government is represented on the relevant board and has access to all project papers and background information. Significant achievements over the past year have included deciding how Scottish taxpayers will be advised of how much SRIT they have paid. Scottish taxpayers will find that information on their annual P60 and will also have access online to the HMRC tax calculator and to individual tax statements.

HMRC has consulted the Scottish Government on options for the Scottish rate and on decisions that have a potential impact on Scottish taxpayers and employers. Agreement has been reached on how to ensure that the appropriate level of tax relief is applied to contributions that are paid into private pensions by Scottish taxpayers for after-tax income. HMRC has been undertaking consultation work with the pensions industry in developing and communicating a solution.

The Public Audit Committee has done some helpful work on audit arrangements for the SRIT, which culminated in its report on the issue on 10 March. The Government will respond to that report shortly. Audit Scotland's engagement with the task of settling the audit framework is also important, as will be its scrutiny of the process once it has been established.

The preparation by HMRC of revised cost estimates for implementing SRIT is a significant development. As the annual report says, the estimated costs are now £35 million to £40 million, compared to £40 million to £45 million in HMRC's original estimate, which was published in November 2010. Our aim continues to be to ensure that value for money is delivered in the project.

In my letter to the committee of 7 January, I set out in detail how the block grant adjustment and reconciliation process in respect of the Scottish rate is expected to work. Although some details remain to be settled, there is now a well-developed understanding of the processes.

We need to agree soon the block grant adjustment mechanism for the devolved taxes, not least to ensure that estimates can be factored into the preparation of the draft Scottish budget this autumn. The UK Government's report describes its proposals. As our report makes clear, the proposals move away from those that are set out in the command paper of November 2010, and I am currently in discussions with the UK Government on the matter. My task is to achieve an outcome from the discussions that the Finance Committee and, indeed, the Parliament, can agree is fair for Scotland.

Parliament has a key role in continuing to provide assurance on and conduct scrutiny of the process. I look forward to discussing these important issues with the committee.

The Convener: Thank you for your opening statement.

John Swinney: There is also material on the fiscal commission, which I assume we will come to under another item.

The Convener: Yes—that is a separate item on the agenda, so we will not ask you about it now.

I have a question on the block grant adjustment. I have to say that I think that the photograph of you in the second annual report was taken when I was at school.

John Swinney: I am not sure what to read into that remark, convener, but I shall think and worry about it for the remainder of the meeting.

The Convener: Okay—let us get to the meat of it, then.

Paragraph 42 of the annual report states:

> "The block grant adjustment in respect of the devolved taxes remains under discussion between Ministers."

What are the bottlenecks to full resolution of the issue?

John Swinney: In essence, we have been in two phases of a discussion. The first phase was the examination of what was in the command paper "Strengthening Scotland's Future", which was considered by Parliament and was the basis on which Parliament gave its consent to the proposals in the Scotland Bill. In the command paper, the United Kingdom Government said:

> "When the smaller taxes are devolved ... there will be a one-off reduction which will then be deducted from the block grant for all future years."

The UK Government has now made it clear that what it really envisaged with those words was a one-off adjustment and then an indexation to ensure that the Scottish public purse does not benefit disproportionately from the devolution of the taxes. As you will imagine, I have contended strongly that that was not what was in the command paper. That was my position in the early part of the discussions with the UK Government.

The UK Government has advanced to us a proposal—which also features in its proposals to the National Assembly for Wales in the recently published Wales Bill command paper—that involves what would be called a form of Barnett abatement. That would be a form of indexation of a one-off adjustment to the block grant, which would involve influencing the Barnett formula. I have indicated to the UK Government that that is not acceptable to us and I have submitted alternative proposals to it in an attempt to resolve the difference of opinion on the question.

The Convener: The Chief Secretary to the Treasury, Danny Alexander MP, has made it clear that he does not want the UK to be disadvantaged by the process, and it is clear that the Scottish Government does not want to be disadvantaged either. What would be the potential financial disadvantage if the UK got its way? What would be the implications for the Scottish budget?

John Swinney: It is difficult for me to quantify the effect of any proposals because I have not seen a proposition from the UK Government that would enable me to answer the question definitively. It depends on two things: the size of the one-off block grant adjustment, which there will be under any circumstance and proposal, and the indexation mechanism, which relates to the potential growth in public expenditure in the UK. At present, I am unable to quantify that figure. I am trying to ensure that we remain clearly aligned to the contents of the command paper and that we have the opportunity to ensure that the growth of tax revenue as a consequence of the devolution of the tax instruments relates to the performance of the Scottish economy and not the performance of public expenditure in the whole of the UK.

The Convener: Paragraph 44 of the annual report states:

> "We have written to HM Treasury proposing a settlement which we believe addresses the concerns of the UK Government, provides an equitable settlement for Scotland and unlike the UK Government's proposals does not amend the ratios used for the Barnett formula."

What are your concerns about those ratios?

John Swinney: I do not think that there is a relevant connection between the devolution of these tax powers and the operation of the Barnett formula. The tax powers are being devolved to increase the Scottish Parliament's accountability and fiscal flexibility. I think that we should be able to establish a connection between the Scottish economy's performance and the performance of the tax base in question and, as a consequence, be able to retain the returns. There should be no on-going relationship with public expenditure once we have made the one-off block grant adjustment that was always envisaged.

The Convener: When the Chief Secretary to the Treasury appeared before the committee in September 2013, we sought clarification on how the Scottish Government and Scottish local authorities might be disadvantaged by not having access to the project rate, which was intended to be used to take forward certain major infrastructure projects. He indicated that he would be happy to consider that point but, as yet, no clarification has been received. Are you able to provide some clarification for the committee?

John Swinney: I will have to come back to the committee with a definitive response in writing to that question after a look at all the current statements and the contents of the budget document from earlier this year.

The Convener: How have you managed to make what is a quite significant reduction in the costs of implementation?

John Swinney: HMRC provided some outline estimates of the likely costs in the original proposition in the command paper. By their nature, those estimates were much more general and, when they were produced, would not have benefited from the detailed scrutiny and project planning work that will have been going on in relation to the system changes and information technology measures. Given that we are meeting the costs, all relevant parties and Scottish Government officials have a clear mandate from me to try, in the discussions, to minimise the cost to the public purse in Scotland and to make sure that the strongest possible scrutiny is being applied to all the measures to ensure that they represent value for money. In short, HMRC's outline estimates, which were presented some time earlier, have been subjected to the rigours of project planning and, as a consequence, we now have a more robust estimate. Nevertheless, the pressure and the approach that I have mandated my officials to apply will continue in order to ensure that we are in as strong a position as possible.

The Convener: We recently took evidence from the Office for Budget Responsibility on receipts from land and buildings transaction tax. As you will probably know, the OBR has, since March 2013, uprated its forecasts for this financial year's receipts for stamp duty land tax—as it is at present—from £372 million to £456 million, which is an increase of about 22 per cent. It has said that that is because house prices have picked up and the number of property transactions in Scotland has increased. Are you happy with the OBR's forecasts on the matter?

John Swinney: The factors that were cited by the OBR are borne out by evidence of a general increase in both house prices and the number of transactions, but whether that represents a 22 per cent increase from the figures that it had set out is a different question altogether. As part of the exercise that the Scottish Government will undertake in projecting future revenues, we will consider all relevant data on the matter and will put our modelling and methodology to the fiscal commission that I will establish in due course, so that they can be independently tested.

09:45

The Convener: I will touch on one further area before I open out the session to committee members.

The committee has previously pointed out that it is unclear how the UK will bear a risk of a deviation from the forecast receipts for SRIT during the transitional period when there is no reconciliation with the actual receipts. For example, if Parliament agreed to an 11 per cent rate as opposed to one of 10 per cent, and the forecast was pessimistic, it is unclear why the Scottish budget would not be disadvantaged if the receipts for the 11 per cent rate were higher than forecast.

John Swinney: Essentially, the variation factor under the arrangements for the Scottish rate of income tax is carried by the Treasury in the transitional period. As we work through the reconciliation of the numbers to establish the comparison between actual receipts and projected receipts, the Treasury will, essentially, be meeting the cost of any gap that arises as a consequence of a deviation between the projections and the amount of receipts that are generated. That is the nature of the proposal that has been advanced by the UK Government.

The Convener: But that reconciliation will not happen in each of the financial years; it will happen at the end of the three-year period.

John Swinney: That is correct. Essentially, we will be working to ensure that we have sufficient comfort in the budgeting arrangements to ensure that any deviation is accommodated in our management of the public finances.

The Convener: Thank you, cabinet secretary. There is a tsunami of members who want to ask questions.

Jamie Hepburn (Cumbernauld and Kilsyth) (SNP): On the issue of the block grant adjustment, I was interested in what you said about the command paper that was presented being the basis on which this Parliament, and, presumably, the Westminster Parliament, considered the legislation. This is shifting the goalposts after the event but, presumably, Parliament might have considered matters somewhat differently if information had been presented differently in the command paper.

John Swinney: In my opinion, the command paper is crystal clear, as was the report of the Scotland Bill Committee, which considered these issues, that the block grant adjustment mechanism is based on a one-off adjustment. That is why such a long period has been taken in pursuing that particular issue in this debate. I thought that it was important that what had clearly been expressed to

Parliament through the command paper and the report of the Scotland Bill Committee was clearly articulated to the UK Government as part of these discussions.

Jamie Hepburn: The convener made an interesting point about the 22 per cent increase in the OBR's estimate of receipts for stamp duty land tax in 2014-15. Accepting the point that you made, which was that there has been an upturn in activity, surely the issue is not so much the 22 per cent increase in the 2014-15 estimate between March 2013 and March 2014 but the fact that, according to the OBR's estimate, receipts from 2012-13 to 2014-15 would go from £283 million to £456 million. I accept that I have only calculated that on paper, but I make that out to be a 60 per cent increase in receipts. That does not seem credible to me.

John Swinney: The nature of my answer to the convener was that activity has increased and property prices are higher, but whether that translates into a 22 per cent increase in the estimated receipts and the scale of increase between 2012-13 and 2014-15 that Mr Hepburn mentioned is a matter of significant debate. I think that that is why a Scottish fiscal commission, in assessing the validity of estimates that are put forward and the basis on which they are formulated, will provide important reassurance.

Jamie Hepburn: My final question relates to the start-up costs for the Scottish rate of income tax. It is welcome that those costs are quite significantly lower than was estimated in November 2010, but can you explain why that is the case?

John Swinney: I do not think that I can say more than I said to the convener. The outline estimate of £40 million to £45 million would have been made by HMRC on a more general project-planning basis. As a result of the rigour that we have applied through the project board and the mandate that my officials have to deliver value for money for the Scottish public purse, we have managed to arrive at a more refined and more reliable estimate, and we will continue to press on that issue.

Michael McMahon (Uddingston and Bellshill) (Lab): You mentioned your desire to bring about an increase in accountability. I know that there are different ways in which people can hold their Government to account and judge the decisions that it has made, but one of them relates to the amount of tax that is taken from them. It would appear that you had some discussions with HMRC about whether the amount of SRIT that is taken should be on people's pay slips. If people do not know how much they are being taxed, the extent to which they can hold their Government to account might be seen to be diminished.

Although the decision not to show that information on people's pay slips might have been taken for practical reasons, because of costs and technicalities, who was consulted on whether we should know what the SRIT element was? Was the business community consulted? Were the trade unions consulted? It is important that we understand why people will not know how much they are being taxed by the Scottish Government.

John Swinney: People will know that, because the information will be set out in their P60 on an annual basis. That was my decision. The judgment that I took was that there would be a greater cost to employers if we made it a requirement for all periodic wage and salary slips to include information about how much SRIT had been paid. I judged that people would get clarity on how much SRIT they were paying from their P60, which is made available annually to all employees. I believed that that would be an appropriate way of minimising the cost to employers, while ensuring that members of the public would be clear about how much SRIT they were paying. They will be able to see that on their P60.

As far as consultation is concerned, I think that we discussed some of those issues with the tax consultation forum, which has a broad membership of employers, and HMRC discussed it with employers.

John Mason (Glasgow Shettleston) (SNP): One or two members have mentioned forecasting LBTT, or SDLT, as it currently is. One thing that concerns me about the OBR forecasts is its point that house prices

"remain well below their longrun trend".

The OBR assumption seems to be that the trend will just continue. I thought that the trend was a bit unhealthy and that people were paying well over the odds for houses, here and elsewhere. I do not know whether the OBR has to assume that the trend will continue because of the methodology that it uses, but I had hoped that some people would learn that they have been paying over the odds for houses and that, in future, prices would settle down at a more reasonable level. Do you have any thoughts on that?

John Swinney: It would be a matter of concern if the housing market took the same course that it took for large parts of the period running up to 2008—that would be undesirable. We can clearly see the implications of that and what it leads to in the wider decisions that people make in the economy and in their economic activities and commitments. I agree that a different and more sustainable approach in the housing market would be desirable.

The reason why I am cautious about the OBR estimates is that I do not think that they will be sufficiently refined to reflect the Scottish market. They will be driven largely by an extrapolation from the assessment across the United Kingdom, and the United Kingdom position will be skewed significantly—enormously, in fact—by what is happening with house prices in London and the south-east. From a lot of the available information, it looks as if the market there is coming back to some of the conditions that existed in the run-up to 2008.

For us, it is important to take the responsible steps that we are taking of assessing the factors in Scotland and testing them with the independent fiscal commission.

John Mason: On borrowing, paragraph 20 of the annual report states:

"It is the view of the Scottish Government that the option of phasing borrowing—for example over a spending review—should be open to the Government."

It goes on to state that you wrote to the UK Government about that on 19 February. Will you explain the thinking behind the idea of phasing the borrowing?

John Swinney: In essence, that is about giving us a bit more flexibility over a spending review period. If an annual limit is put in place over the duration of a spending review and if we wanted to use the maximum amount of borrowing flexibility, would we have to borrow that in three equal components, or is there an argument for borrowing a more significant amount in one period in the spending review to support the roll-out of a major capital project or element of our capital programme? We simply want to have that flexibility.

John Mason: Would that necessarily mean that you would spend more in year 1 and less in years 2 and 3, or would it sometimes be the other way round?

John Swinney: It would depend on the choice. In essence, we want to have flexibility to make that choice and to be driven by the contents of our capital programme rather than an obligation to borrow the same amount of money in three annual instalments, if we were using the maximum amount of borrowing capability. We might want to undertake a capital project for which we wish to borrow because our capital departmental expenditure limit allocation is not sufficient. However, we might not need to borrow anything in year 1 but need to borrow a lot in year 2 and less in year 3. That is the type of scenario that I am talking about.

John Mason: So that would be similar to the Forth replacement crossing—we know that it is coming and that there will be a big bump in one or two years.

John Swinney: Correct. We just want to have that flexibility.

John Mason: With regard to landfill tax, the annual report that we have from the UK Government states:

"Draft legislation setting out the necessary changes to existing legislation for the disapplication of Landfill tax ... will be published in autumn 2014."

That is obviously Westminster's timetable, but it sounds quite late to me. We are introducing a new tax and Westminster is only going to think about stopping the old one in the autumn.

John Swinney: To be fair to the UK Government, I do not think that it is saying that it is thinking about stopping the old tax; it is the technical language that is used. I find myself in the very unusual situation of being fair to the UK Government, but that is consistent with my reputation for fairness in all such questions. Those are simply the technical provisions to conclude the tax powers being held at Westminster. It is nothing more to be worried about than that.

10:00

John Mason: So we can be relaxed about that, then. That is reassuring—thank you.

I was interested in some of the comments that Mr Carmichael made in his foreword to the annual report. I would be interested in your thoughts. He discusses the "two new Scottish taxes", which are land and buildings transaction tax and landfill tax. He suggests:

"All of this as part of the United Kingdom, with the strength and support of the UK's economy and resources. This is devolution in action."

I thought that those two taxes were totally under our control. I did not see how the "UK's economy and resources" were having any impact on either land and buildings transaction tax or landfill tax. Is that your reading of it, too?

John Swinney: That would be my reading of the situation as well, yes.

John Mason: Mr Carmichael goes on to say:

"This Coalition Government made a commitment to people in Scotland to deliver the recommendations of the Calman Commission".

Admittedly, he does not say "all the recommendations" of the Calman commission, but neither does he say "some of the recommendations" of the Calman commission. I understood that those recommendations included things such as air passenger duty that have not been devolved. Could you comment on that statement that the UK Government is delivering

"the recommendations of the Calman Commission"?

John Swinney: It is a matter of fact that the UK Government is not delivering all the recommendations of the Calman commission.

John Mason: Also in that foreword, Mr Carmichael refers to the people of Scotland making a choice and to the question:

"should Scotland remain part of a strong, successful United Kingdom"?

Is it your opinion that the United Kingdom is strong and successful?

John Swinney: It will not come as much of a surprise to the committee that I am a supporter of the arguments for Scottish independence, so I do not find myself in accord with the secretary of state on that point.

John Mason: Thank you.

Michael McMahon: Thank you for your clarification on that.

Gavin Brown (Lothian) (Con): If it is okay, I might return to the Scotland Act 2012.

Is the figure of £35 million to £40 million a sort of shared estimate by the Scottish Government and the UK Government? Are you both saying that you think that that is what it will end up costing to implement the Scottish rate of income tax?

John Swinney: That estimate has emerged from the project board, in which the Scottish Government is a participant. We consider it to be robust.

Gavin Brown: I will come on to the block grant adjustment, but before I do, I want to ask about paragraphs 75 to 77 of the UK Government's annual report on the act, which have the subheading "Cash reserve". They outline the mechanism of the cash reserve. Does the Scottish Government have a position on that, or a plan? Does it intend to do anything on that, either in this financial year or in the next financial year?

John Swinney: The arrangements that are cited by the UK Government in those paragraphs are an accurate representation of the facility, but at this stage the Scottish Government has made no provision to contribute to that cash reserve. Obviously, however, there are budget statements yet to come.

Gavin Brown: Is the matter under discussion?

John Swinney: All these issues are always under discussion.

Gavin Brown: On the block grant adjustment, I will deal first with the Scottish rate of income tax. Is it fair to say that the Scottish Government and the UK Government broadly agree on the overall mechanism?

John Swinney: For the Scottish rate of income tax?

Gavin Brown: Yes.

John Swinney: Yes, it is.

Gavin Brown: I have a minor question. It appears to be said quite frequently that there will be two or three transitional years. Will it be two transitional years or three transitional years, or is it a case of seeing how things will develop and taking a decision at a later date?

John Swinney: That is correct. There is still discussion about the appropriate transitional period. It is fair to say that nobody is absolutely certain how all the reconciliation arrangements will work themselves out, so some flexibility is being retained, perhaps to spread it over a longer period rather than a shorter one.

Gavin Brown: I turn to the block grant adjustment for the devolved taxes. Is there likely to be an agreement that rolls the two taxes together or will the mechanism for each tax be treated separately and on its own merits?

John Swinney: That will be a product of whatever agreement we arrive at, so I cannot predict whether the two will be rolled together. It would desirable if they were.

Gavin Brown: You said to the convener that one of the bottlenecks was indexation. I suppose that you are limited in what you can say, but if we put indexation to one side, is there broad agreement on what the one-off figure would be or is there still some disagreement about what represents a fair figure?

John Swinney: We cannot separate agreement about the one-off adjustment from indexation. To go back to the original starting point, which I probably discussed with the committee when I was here a year ago to speak about the previous section 33 report, I concentrated on the provision in the command paper that, in my view, is the clearest distillation of the position, which is that there should be a one-off adjustment and that should be the end of the story. If we add in indexation, which the UK Government has done, it becomes clear to me that we cannot come to a conclusion on the one-off adjustment without also coming to a conclusion on the indexation arrangements, if we are going to have any of those in the first place.

Gavin Brown: Okay. I understand that.

You say in your paper that you have written to the UK Government and made a proposal. It says in its report that it has received the proposal and is considering it. What was the approximate date on which the proposal was put to the UK Government?

John Swinney: It was 10 April.

Gavin Brown: Perhaps there is no protocol for this, but is there a date by which you expect an answer or have you been given an indication of when to expect one?

John Swinney: We have not been given an indication of when we should expect an answer. I am keen to ensure that the issue is resolved sooner rather than later—it would be better for the good administration of budgeting processes if that were the case—and I will work to effect that.

Gavin Brown: At paragraph 65 on page 28 of its report, the UK Government talks about taking an approach similar to the one that was taken when business rates were devolved to Scotland. Over several paragraphs, it goes on to talk about how that might operate. What would the Scottish Government's primary objection be to mirroring what happened when business rates were devolved? Is the situation so different?

John Swinney: I do not quite understand the connection, to be honest. The devolution of business rates must have happened 15 years ago. I was not intimately involved in the discussions about that, so I do not have all the details to hand, but there was a budget line in UK public expenditure on business rates. Therefore, I can understand how, when the function was devolved, comparability went from 100 per cent to zero, because there was a budget line associated with its devolution. There is no budget line associated with the devolution of stamp duty land tax and landfill tax, so I cannot quite understand what point is being made about the example of business rates somehow being a touchstone for how we might approach the devolution of those taxes. I simply cannot understand the basis of that.

Malcolm Chisholm (Edinburgh Northern and Leith) (Lab): In a way, Gavin Brown has half dealt with this question. I think that you would agree that, if we get the result that you do not want and have further fiscal devolution, income tax will become the crucial issue, particularly if it is devolved further.

You said to Gavin Brown that you had agreed the block grant adjustment mechanism—the Holtham mechanism is what it is normally called—with the UK Government. Does that mean that you are entirely happy with it or have you agreed it because that is the nature of negotiations?

John Swinney: It is an infinitely preferable approach to the one that was proposed by the Calman commission and in the command paper.

Malcolm Chisholm: Just taking the years of devolution for the sake of argument, do you happen to know in how many years the non-savings, non-dividend tax base in Scotland has grown more quickly than the UK average?

John Swinney: I do not have that information to hand, but I could explore it.

Malcolm Chisholm: It would be interesting for us and the public to know that.

Jean Urquhart (Highlands and Islands) (Ind): Cabinet secretary, I got ticked off last week for asking questions that were too long and rambly, so I will keep my questions short.

John Swinney: I hope that there is no ticking off for people who give long, rambling answers, or we certainly will be in trouble.

Jean Urquhart: That was not discussed.

What is the point of the Scottish rate of income tax?

John Swinney: The only point of it is to give the Scottish Parliament more involvement in the setting of one element of Scotland's income tax base.

Jean Urquhart: However, if we were to adjust it, that would not affect Scotland's income, would it? That would be compensated for in the block grant adjustment.

John Swinney: It would have an effect because, if the Parliament decided not to collect as much tax as was envisaged by the block of taxation that was devolved or if it decided to collect more of that tax, that would mean a variation in the amount of money that it had available to deploy in public expenditure.

Jean Urquhart: There would be no change to the Barnett formula calculation of Scotland's block grant.

John Swinney: The effect would be more on the amount of money that the Parliament would have available to allocate to public expenditure. There would be a block grant adjustment, but the decision that the Parliament took to raise or to lower the rate of taxation would have an effect on the amount of money that we would have available to spend.

Jean Urquhart: My other question is about the Scottish Government's borrowing powers. I will try to keep it short.

One of the biggest concerns in local government finance is about the cost of continuing public-private partnership and private finance initiative repayments, which are extraordinarily harsh and about which local authorities can do nothing. If the Scottish Government is allowed to use its borrowing powers to do so, would it consider the kind of investment that might save money in the long run if there was a possibility of paying off some of the 20 and 30-year arrangements for school, hospital and other capital expenditure programmes?

10:15

John Swinney: An exploration of each of the projects involved would have to be undertaken, because all the PFI commitments that were entered into were entered into on a specific contractual basis for the particular asset or group of assets involved, and there are probably differences between almost every project that is in place. I have looked previously at whether it would be possible to renegotiate some of those terms of agreement and, in almost all cases, the ability to renegotiate the contents of the agreement was so constrained that it was impossible to secure a better deal.

In some circumstances, the contract prevented any reopening of the contract during its 25-year life. In others that could be reopened, the public sector had no ability to insist on that happening; the contract could be reopened only with the consent of the special purpose vehicle party. In many circumstances, if there was to be any gain or benefit from the renegotiation, a significant proportion of the proceeds had to go to the special purpose vehicle in the private sector. That was part of the contractual arrangements that were entered into at the outset of the PFI contracts.

The re-examining of PFI contracts has been a priority for me. I have reluctantly come to the conclusion that the room for being able to renegotiate such contracts is limited, if not non-existent. That serves to illustrate the fact that we must always take the greatest of care when we enter into such negotiations in the future.

The wider question about the sustainability of borrowing is an important one. The committee will be familiar with what I have put in place in relation to the wider fiscal framework within the devolved arrangements that we have. I have set a limit on the amount of borrowing or revenue-financed investment that we undertake of 5 per cent of our departmental expenditure limit budget, essentially to provide a framework to discipline how many commitments we take on and what we envisage being utilised. Of course, the same principles apply to local authorities, whose conduct must be consistent with the prudential code.

The Convener: Thank you. That concludes questions from colleagues.

I have just one further question. Time is marching on as regards the block grant adjustment. If no agreement is reached between the Scottish Government and the UK Government, will the UK Government just impose its own view on the issue?

John Swinney: That would be utterly undesirable and it would be a dreadful mistake by the UK Government if it decided to do so.

The Convener: Thank you.

Okay, colleagues. I will not call a break, because we are only 48 minutes into today’s deliberations and we have the same witnesses for agenda item 2 as we have had for agenda item 1.

Scottish Fiscal Commission

10:18

The Convener: The next item of business is to take evidence on the Scottish Government's plans for a Scottish fiscal commission. The committee published its "Report on proposals for a Scottish Fiscal Commission" in February, and members have copies of the Scottish Government response. Before moving to questions from members, I invite the cabinet secretary to make an opening statement.

John Swinney: Thank you, convener. I am pleased to have this opportunity to provide the committee with further information on my proposals to establish a Scottish fiscal commission. I thank the committee for its report of 7 February, which was of substantial assistance to the Government in drawing together the views of a range of experts as well as the thoughtful contribution that was made by the Finance Committee.

The Scottish fiscal commission will be established this summer to scrutinise Scottish Government forecasts of receipts from land and buildings transaction tax and Scottish landfill tax. The commission will also be asked to scrutinise the economic factors that underpin the forecast of receipts for non-domestic rates. The commission will provide reassurance over the reasonableness and integrity of our tax receipt forecast ahead of the introduction of the 2015-16 draft Scottish budget in the autumn. The commission will report its findings to the Parliament and to the public, which will enhance the strength and the credibility of the Scottish Government's tax forecasts.

Initially, the Scottish fiscal commission will be established on a non-statutory basis, but administrative safeguards will be put in place to protect its independence. I fully recognise the need for the commission to be structurally and operationally independent of the Scottish Government and that giving the commission a basis in statute will be important in the future. If possible, I intend to introduce legislation to underpin the commission in the current parliamentary session.

The role and remit of the commission will continue to be reviewed and expanded as the Parliament's fiscal powers are enhanced. I also intend to review the role of the commission in relation to the Scottish rate of income tax prior to its planned introduction in April 2016.

The commission will have three part-time members, one of whom will act as chair. Commission members will bring independent minds and strong economic and analytical skills to bear on the Scottish Government's tax forecasts. To protect the commission's independence, I will make appointments for a single term of office of between three and five years. That will allow for rotation of members of the commission in line with good governance practice, while making it possible to manage the retention and transfer of skills and experience. People who are appointed to the commission will not be remunerated, but the Scottish Government will meet all reasonable expenses that are incurred in the course of the commission's business. In addition, we will make available to the commission a modest budget to cover analytical and other necessary work.

I very much welcome the role that the Scottish Parliament will play in approving nominations for appointment to the commission. I will formally notify the committee of my nominations once candidates have agreed to be recommended to the Parliament for appointment. I believe that the scrutiny that the committee will bring to the appointments process will further strengthen the credibility and the authority of the commission.

The creation of a Scottish fiscal commission is another important milestone on the journey to enhance Scotland's fiscal powers. I believe that the commission will play a key role in supporting the exercise of the tax powers that were devolved to the Parliament under the Scotland Act 2012. What is proposed is proportionate to those powers but creates a basis for the commission to expand its functions over time, alongside the expansion of the Parliament's fiscal powers.

I am pleased to announce to Parliament the creation of the commission and to have the opportunity to answer any questions that the committee has on those plans.

The Convener: Thank you very much for that fairly short but comprehensive and helpful opening statement, cabinet secretary. You have answered some of the questions that I intended to ask, so I will move on to some others.

One of the recommendations that we made in our report was:

> "as the OBR produces Scottish tax forecasts twice a year, the SFC should also provide a commentary twice a year which should include the views of the SFC on the economic determinants underpinning the tax revenue forecasts".

However, in your response, you suggested that scrutiny and commentary should be provided on

> "a frequency that best suits the Scottish budgeting cycle and supports the work of the Parliament in holding Ministers to account on fiscal issues."

You suggested that a commentary should be produced

> "alongside the draft Budget document each autumn."

Will the SFC also comment on UK budgets as they impact on Scotland?

John Swinney: That will not be part of the commission's remit.

The Convener: Why is that?

John Swinney: As it is founded, the commission will have a particular role to play in providing us with a critique and a validation of the estimates that we make in relation to landfill tax and the land and buildings transaction tax. As the Scottish rate of income tax develops, it will also have a role to play with regard to the estimating that we do in relation to that tax.

I want to ensure that the commission performs a highly focused role that enables Parliament to come to reasoned and considered judgments on all the questions that relate to the judgments that require to be made on the tax powers in question. Clearly, a commentary on the UK Government budget is given by the Office for Budget Responsibility and can be given by Parliament on any occasion on which it sees fit to do so.

The Convener: You also said in your response that national non-domestic rates income modelling involves assumptions about bad debts and appeal losses. You observed:

> "These are commercial assumptions which are based on experience and on assessments made within SG and by local authorities. It is less clear that the SFC will have expertise in these areas."

However, you went on to say:

> "the SFC should comment annually on NDRI forecasts at the time of the publication of the draft Budget document."

If the SFC will not have much expertise in that area, why are you keen for it to comment on it?

John Swinney: I was seeking to make a distinction between the factors on which I think that the commission will be able to add input—which will be to do with buoyancy and performance in the economy and what effect that is likely to have on the non-domestic rates take—and other factors.

As part of the annual calculation of the non-domestic rates estimates, we make an assessment of the appeal losses and bad debts of local authorities across the country. Essentially, the decisions that are taken to determine the effect of those factors on the overall NDRI totals are operational decisions, which I do not think are affected by economic performance. I do not think that the commission will have the necessary capability to consider those issues, some of which are commercially sensitive in that they relate to negotiations to do with appeals that are undertaken by assessors with interested parties.

I will discuss such matters with the members of the commission once they have been appointed, but that is my judgment on the areas of involvement and expertise that they will have.

The Convener: I will ask one more question before I allow colleagues to enter the discussion.

In paragraph 4 of his submission for the next item on our agenda, Professor John Kay—who is sitting right behind you—said:

> "in my view the OBR has been established too much as a body to give validation to what was formerly the forecasting operations of the UK Treasury, and too little as a body exercising the functions described in its title—the promotion of budget responsibility."

How would the Scottish fiscal commission differ from the OBR in that regard?

John Swinney: As we currently envisage its role—and as I think was established in the evidence that I gave to the committee; I was certainly struck by what the committee said in its report on the matter—the commission will be a focused body that will look at the particular elements of tax collection for which we are assuming responsibility in Scotland and it will provide, as I described a moment ago, the necessary critique and validation of the estimates that are put forward.

There is nothing wrong with validation of the estimates as long as the critique has been done in the first place. In the light of the evidence that the committee took and the report that it produced, we have arrived at the proposition that the commission should have a very focused role, which I am happy to implement.

As I have indicated, there will be a dynamism to the issue, which will be driven by the constitutional debate, so we may well need to revisit some of the details to do with the role and the focus of the commission in the light of that debate.

The Convener: Thank you very much, cabinet secretary.

For the first time in my three years as convener of the committee, members have no questions to ask. [*Interruption*.] Oh, they do! I did drop a hint that that was to be my final question and not one member indicated that they wanted to ask one. They need to be a wee bit smarter next time—under the previous item, I said by way of a hint that a tsunami of members wanted to ask questions and that got a response.

It looks as if members have some questions after all, so I am afraid that the cabinet secretary will not get off as lightly as he might have suspected.

Gavin Brown: I will begin with a couple of simple technical questions. What is the rough timescale for the legislation that you intend to introduce?

John Swinney: As things stand, the earliest I could see that happening would be in the final year of the present parliamentary session.

10:30

Gavin Brown: So it would be 2015-16, as it were.

John Swinney: Just to be absolutely clear, it would be the parliamentary year starting in the autumn of 2015.

Gavin Brown: As opposed to the financial year.

I presume that you would want to have the interim remit for the fiscal commission in place by the summer. I think that that is what you suggested.

John Swinney: What I plan to do is this, convener—although I am obviously in the committee's hands in this respect, because it has a significant role to play in the process. Reasonably shortly, I would expect to share with the committee the nominees who I intend to put forward. I would appreciate it if the committee could, in a reasonably short timescale, consider the nominees I suggest and thereafter make the appropriate reports that it sees fit to make to Parliament to secure parliamentary agreement for the nominations that I make. Obviously, with that I will clarify the remit and other working arrangements of the commission.

Gavin Brown: Normally, cabinet secretary, I encourage you to cut costs and to think carefully about expenditure, but I think that I heard you say that there would be no remuneration for any of the commissioners and that there would be a budget of about £20,000 for administration, resourcing and so on. Taking those two aspects together, do you think that that will be enough resources to make the commission robust and to enable it to do the thorough job that we all need it to do?

John Swinney: Yes. The issue about remunerating members is connected with whether or not the SFC has a statutory basis, so that is a short-term issue for the 2014-15 financial and parliamentary year. If the commission had a statutory basis, that position could change.

I will be guided by the commission on the nature of the resource and expertise that it requires to fulfil the functions that it is given. I will have a very open discussion with the commission about that issue. I am clear that the commission has to be able to fulfil the role that Parliament envisages for it, and I will ensure that it is properly equipped with the necessary resources to enable that to be the case.

Gavin Brown: Finally, one of the recommendations in the committee's report was:

> "The Scottish Government should consider the option of inviting the SFC to produce the official macro-economic and fiscal forecasts".

The Scottish Government did not accept that recommendation, but in its response to the committee it said:

> "The Scottish Government believes that responsibility for carrying out economic and fiscal forecasts, including tax receipt forecasts, should lie with the Scottish Government and that primary accountability should be of Ministers to the Parliament."

Can I take it from that statement that the Scottish Government plans to carry out and publish economic forecasts?

John Swinney: We undertake that type of activity on an on-going basis.

Gavin Brown: But, as I understand it, you do not publish official Scottish Government economic forecasts.

John Swinney: For example, the most recent "State of the Economy" report that the Scottish Government's chief economist published last week—if my memory serves me; it was maybe the week before—includes a forecast about the pattern of development of the Scottish economy. That is what I would call a forecast.

Gavin Brown: I know that you look at various forecasts and take views—I read the economic report—but I did not believe that those were official Scottish Government economic forecasts. The way that I read the Scottish Government's response led me to wonder whether you will now produce official Scottish Government economic forecasts.

John Swinney: The point that I made in the response to the committee's report is in the context of the debate that the committee had about what the commission's role should be. Should the commission essentially tell me, "We think that you will raise this amount of money from these taxes," in response to which I should say, "That is fine; that is the commission's view, so we shall just put that figure into the budget," or should my officials produce an estimate and test it for validation with the fiscal commission?

When I made that point, I was trying to clarify that we see it as our responsibility as ministers to be accountable for assessing the pattern and development of the Scottish economy and then, when necessary, to seek the critique and the validation of the fiscal commission about the content of our estimates.

The Convener: Thank you, cabinet secretary. We will be discussing the roles of your appointees with them on 28 May.

Malcolm Chisholm: I have a general question, which follows on quite well from Gavin Brown's last point. I think that it is true to say that there is a bit of disappointment among the committee members because you have not gone quite as far as we were suggesting. However, I suspect that there is even more disappointment among the economists. Professor Kay has already been quoted in that regard, and his submission says:

"The critical question is 'is the current level of public sector service provision sustainable at current levels of taxation?'"

That connects with a point that Professor David Bell made in his evidence to us.

You will also have seen the very passionate article by Jeremy Peat in *The Herald* two days ago. He must be very disappointed because, at the end of the article, he said that the new body in Scotland

"should be ... not just an informed commentator on Government figures but the actual provider of key forecasts."

Earlier on in the article, he talked about the importance of having a body

"To consider the long-term health of the economy"

and so on.

My question is of a general nature. I am curious to know whether your limited remit for the new body is driven fundamentally by the fact that, initially, it will have a very small amount of taxation to deal with or whether—which perhaps was suggested by your previous answer—you have a fundamental objection in principle to such a body having a wider role.

Clearly, the future is unknown but if the limited remit is driven by the former fact, I imagine that you would be open to the body having a wider role in the future. However, a few minutes ago you talked about looking at the detail, so my sense is that you are certainly not sympathetic to the idea of a body with wider powers—I was going to say that you are perhaps quite hostile. The idea has been proposed by many distinguished economists and has been supported—at least to a certain extent—by this committee.

John Swinney: I struggle with Mr Chisholm's explanation of the views of the committee in its report because my reading of the committee report—again, it is my reading—was that the committee was encouraging me to establish a body and I got a very clear sense from my previous evidence session on this topic that the body should undertake a proportionate task in relation to the taxes that we have to deal with—LBTT and landfill tax.

I remember clearly setting out my view to the committee—which I thought was a view that was broadly agreed with within the committee—that we already have a fairly extensive commentary network about the economic performance and the economic future of Scotland and that there is no need to add an additional fiscal commission to explore that territory.

The proposals that I am putting forward relate very directly to the particular tax powers that we have. I have indicated to the committee that the role of the body will be enhanced when the SRIT emerges. It will also be the subject of review when we are clearer about the constitutional direction that the country is going to take.

All those comments are designed by me to say that I see a dynamic about this whole process. We will start off with a body that focuses on what we have the statutory function to do and consider at this particular time, but we remain open—I remain open—to considering how its role can be expanded once a broader range of responsibilities come to the Scottish Parliament.

The Convener: Do you expect to use the experiences of the interim Scottish fiscal commission to inform proposals to establish it on a statutory basis?

John Swinney: Yes. I would also seek to dwell very heavily on the material that we have discussed as part of the committee's inquiry—and the Government response to the committee report—to ensure that we establish the commission on the most appropriate footing to begin with.

The Convener: That ends your evidence for today. I thank colleagues for their questions and I thank you for your evidence, cabinet secretary. I suspend the meeting to enable members to have a natural break and to enable a change of witnesses.

10:40

Meeting suspended.

10:50

On resuming—

Scotland's Public Finances Post-2014

The Convener: Our final item of business is to take evidence on Scotland's public finances post-2014 from Professor John Kay, Professor Gavin McCrone and Professor Peter McGregor.

Members have copies of the written submissions that our witnesses have provided, so we will go straight to questions from me, to be followed by questions from other members of the committee.

Last week, the equivalent session took some three and a quarter hours. In our discussions afterwards, I was chastised by one or two members of the committee for being a bit too liberal in allowing people to spend so much time on questions. I am not very keen on holding committee members back, but I ask everyone to apply a self-denying ordinance, which I will try to apply, too. I do not intend to hog the limelight for too long. That said, I might put questions to one individual initially—for example, the first question will be to Professor McCrone—but I would be quite happy for colleagues on the panel to comment, too, if they so wish. That will make for a much more interesting discussion.

Without further ado, we shall kick off. Professor McCrone, in the first paragraph of your submission, you say:

> "The position I take is that Scotland could perfectly well manage as an independent country. It is even possible that it might eventually do better economically than remaining as a part of the UK; but this would depend on the wisdom or otherwise of the policies adopted by Government."

You went on to give a number of caveats.

The last sentence of that paragraph says that, following independence,

> "There could be a loss of some key industries."

I take on board your point that it

> "would depend on the wisdom or otherwise of the policies adopted by Government."

Many countries have been able to have very strong economies through sound economic policies. Switzerland's economy is bigger than that of the Ukraine, which has seven times the population of Switzerland. Singapore's gross domestic product per capita is 15 times that of neighbouring Indonesia. Obviously, the policies that Governments adopt are key.

Will you elaborate on what you said in the Scottish context and touch on the issue of the

> "loss of some key industries"?

Professor Gavin McCrone: I take the view that Scotland could function perfectly well as an independent country. There is no reason why it should not do as least as well as Ireland, which was much poorer when it became independent. However, a country cannot come out of a union that has lasted for 300 years without there being all sorts of implications and some potential damage.

The two industries that I would be most worried about are the finance industry, in which a number of institutions are wondering whether they should stay in Scotland or go south, and the defence industry. I did not deal with defence in my book or in the paper. It is a difficult subject, but it is plain that some of the major defence orders might be at risk, because Governments tend to place their defence orders in their own countries.

A lot depends on how independence would happen. If there is sweetness and light all around, the damage can be minimised, but if the break-up were to be acrimonious, things such as the tourism industry could also be affected.

The Convener: Okay. Do Professor Kay and Professor McGregor wish to add to that?

Professor John Kay: I do not have anything to add on defence. On the financial services industry, my experience of talking to people in the industry is that when they express unease it is very hard to work out what the unease is about, when they are pressed. That may mean that it does not entirely matter, but it matters a bit in relation to those businesses' customers. Having said in print a couple of weeks ago what I have just said, I now have an email inbox that is full of mail from people in England who have said that they have a policy with Standard Life and would be very worried if Scotland became independent. I have no idea what they would be worried about; nor do they, really, but the fact that they would be worried is genuinely a problem for Standard Life, whether either it or they have any basis for their worries.

Professor Peter McGregor (University of Strathclyde): I do not have anything to add, other than to say that the point about the policies that would be pursued by the Scottish Government post-independence is clearly crucial, because they will determine the success or otherwise of independence in the longer term. I agree that in the short term there are likely to be costs associated with independence.

The Convener: I will follow up on Professor McCrone's comments. The Scottish Government has pointed out that although Scotland contributes 9.9 per cent of the UK's taxes, only about 5.6 per cent of defence expenditure is in Scotland. The Scottish Government would be looking for a policy of joint procurement whereby Scotland would buy equipment from south of the border and the UK Government would buy equipment from here, so that there would be a balance. It has been suggested that Scotland's defence budget would reduce by £2.5 billion, which would free up resources to spend on other areas of Scottish life, such as schools, roads and hospitals. What is your comment on that, Professor McCrone?

Professor McCrone: That would be fine but, of course, joint procurement would have to be negotiated, and I am not sure how such negotiations would go. There is not much history of countries engaging in joint procurement with one another, although I suppose Britain has bought quite a lot of stuff from the Americans. However, joint procurement is a potential risk.

As for the other things that have been discussed, the only point that I would add is that a fair bit in the financial sector might depend on whether Scotland were to succeed in maintaining a currency union with the rest of the UK or had to adopt its own currency. You will see from my paper that I think that the latter is more likely in the end, even though there might be an attempt at the start to keep the same currency. That is not something that Governments can entirely decide for themselves. The break-up of the Czech and Slovak monetary union showed that the markets can force that quite easily.

The Convener: Okay. The fiscal commission working group said that a shared currency would provide

"clear governance arrangements, a framework for financial stability and a consistent regulatory structure".

The group also said that a shared currency would ensure no transaction costs and enhance trade, competition, efficiency and flexibility in the main interests of both Scotland and the UK; and that the risk of an asymmetric shock would be remote and therefore should not inhibit a currency union.

What do you think of that statement, Professor Kay?

Professor Kay: From the point of view of Scotland, a currency union with England would be the best outcome, if it could be negotiated. I was sceptical, even before the various announcements from Westminster this year, about whether a currency union could be negotiated. I do not think that those announcements rule out the possibility of a currency union if Scotland did, indeed, vote for independence, but they clearly make it more difficult.

I think that the other options are, first, an independent currency, to which Professor McCrone referred. I have thought about the issue more and it seems to me that, secondly, the unilateral option might have more to commend it than seems to be the case at first sight: Scotland would simply go on using the pound anyway.

The Convener: What would be the advantages of that scenario?

Professor Kay: The advantages would be the stability and low transaction costs that are outlined in the fiscal commission report that the convener mentioned. The disadvantage would be the loss of some policy flexibility as a result of not being able to change the exchange rate vis-à-vis the English pound and not having any freedom in monetary policy. However, the practical reality is that an independent Scotland would not have any freedom in monetary policy anyway.

Professor McGregor: I basically agree with what has just been said about monetary union. Probably the best outcome for Scotland would be the maintenance of a monetary union with the rest of the UK.

11:00

However, that is probably the best option but it is not costless because, within a monetary union, Scotland would give up the right to an independent monetary policy, which is significant. There would also almost certainly be severe constraints on the overall fiscal stance that Scotland could adopt. Experience in the eurozone suggests that that is more an issue now than it has been previously. In a monetary union, Scotland would give up those two significant powers—although I do not mean "give up" exactly, because Scotland has not had them for many years. There are costs associated with monetary union.

In terms of the limitation on the macroeconomic policy stance, however, there are also—as has been emphasised—major benefits to monetary union, particularly in terms of transaction costs. That is really important and it dominates the argument because of the extent of interdependence between Scotland and the rest of the UK, especially in trade flow, which is asymmetric because Scotland is more dependent on the rest of the UK as an export market. In my judgment, monetary union would be the best net outcome for Scotland, but it is not costless.

The Convener: You mentioned the eurozone, but it is comprised of 17 countries with a range of productivity levels; for example, Greece's productivity is 40 per cent of Germany's. Given that Finland, the Netherlands and so on seem to be able to exert their own fiscal policies, why would it be difficult for Scotland, as part of a currency union of only two countries in which productivity is not too different, to exert its own fiscal policies in the way that the more successful countries in the eurozone do?

Professor McGregor: One problem is that the degree of integration between the rest of the UK and Scotland makes the situation more challenging; it means that the constraints will be more severe, if anything. You would have to ensure that the fiscal policy stance that an independent Scotland pursues would not threaten the permanently fixed exchange rate. Markets and market forces will have a major influence on that. I am not saying that it is not possible to have some independence in fiscal policy, but it will be much more constrained under a permanently fixed exchange rate—given that you are committed to maintaining the value of the exchange rate and the monetary union—than it would be in the absence of a monetary union.

Professor McCrone: The problem that I see is that I cannot imagine a Chancellor of the Exchequer for the remainder of the United Kingdom, with no electoral responsibility for Scotland, being prepared to put taxpayers at risk in the rest of the country for the sake of Scottish debt or bank debt in Scotland. I just do not think that they will do that, and it is probably the main reason why we have been hearing from George Osborne and the others that they will not contemplate currency union.

Of course, negotiations will take place and we will see what happens in the event of independence.

Professor Kay: When I gave my first answer about Standard Life, one of the points behind it was that if people believe that something is true, that matters even if it is not true. We have a similar problem here in that it is now conventional wisdom within the eurozone that you can have currency union only if you are on a path towards fiscal and banking union. I do not think that that is true, but there is almost no point in our debating whether it is true, because people in markets and political circles believe that it is true. The result is that if Scotland votes for independence and we hold negotiations over monetary union, the rest of the UK's Treasury will lay down conditions that will be difficult for a Scottish Government to accept because the rest of the UK will demand control over the banking system and fiscal policy in Scotland that it will not be willing to concede to a Scottish Government vis-à-vis the rest of the UK.

The almost intractable problem on which the negotiations would fail would be the demand for supervision of Scotland's fiscal policy. Either Scotland would concede that, in which case you would be conceding most of the economic policy levers that you would hope to gain from independence, or Scotland would refuse, in which case monetary union could not go ahead in that form.

The Convener: Professor McCrone also said that banking might leave Scotland. I had a private meeting with some senior bankers who said that the likelihood of, for example, the Royal Bank of Scotland moving its 3,000 staff to London—where they would all have to find houses, which would probably not be of the quality that they have in Edinburgh, and schools for their children, and would have to commute further and cope with a higher cost of living—and spending money on new premises for all those people to work in is probably zero. They said that, if a bank moved, it would be more to do with moving the place where it was registered rather than the place where it has its presence and employs staff. What is your view on that?

Professor McCrone: If that is so, that is good news. Of course living in London is much less agreeable than living in Edinburgh. I have been aware of that for a long time.

Professor Kay: I am aware of it, too.

Professor McCrone: However, we must disentangle a number of points. One of Iceland's banks had a branch in the UK and the other had a subsidiary company in the UK. When Iceland got into trouble, the British Government looked to the Icelandic Government to protect the depositors in the branch, but not in the subsidiary company, because that was separately regulated and, therefore, guaranteed by the UK deposit insurance scheme.

It would be terribly important for the banks in Scotland to ensure that whatever they were doing in England was separately regulated by the Westminster Government down there and protected by the bank deposit insurance scheme down there. Otherwise, if something were to go wrong, they could find themselves having to bail out depositors down south, which could, in effect, bankrupt Scotland. That is important.

It is not just a question of the depositors; it is also a question of the debt. What happened in Ireland was that the Government decided to honour the debt of banks—the bonds and all the rest of it—which nearly bankrupted the Irish economy.

There are a lot of difficulties in this area. If the banks were to move south, I presume that they would trade in Scotland through subsidiaries—the Bank of Scotland, in the case of Lloyd's, and the Royal Bank of Scotland, in the case of RBS. Those subsidiary companies would be regulated in Scotland and might do a great deal of work for the whole group. That would be a safer situation than having major banks located in Scotland, with all the risks that would have to be borne if something were to go wrong with them.

Professor Kay: We keep coming up against the problem of people believing that things are true even if they are not true or should not be true. In this discussion, we have yet another example. We have created the idea that if a bank erects a brass plate in some location and says, "This is our headquarters," the taxpayers of the country where that brass plate is located become liable for all the debts of that bank. That is a strange idea; the Scottish Government should be in great haste to say that, as far as Scotland is concerned, that is not true.

As far as Ireland was concerned, as the result of a rather foolish commitment that was given overnight by the Irish finance ministers, it was true. Currently, it seems that the UK and American Governments believe that it is true, and the German Government certainly acts as if it is true. I think that they will find that that will cost them a lot of money, one day.

Dr McCrone is right to suggest that RBS would move its brass plate from Scotland to London. However, I do not think that that matters at all. For the reasons that were described, I do not think that RBS is going to move 3,000 staff, or any other number of staff, from Scotland to London. I cannot see why it should.

However, the subsidiarisation point is extremely important. With regard to insurance as well as banking, as long as the European Union rules stay as they are, a Scottish Government should ensure that, when Scottish insurance companies or banks operate outside Scotland, they do so through subsidiaries in those countries, rather than as branches. That will mean that Scottish depositors, policy holders and taxpayers would not be on the hook for activities that take place outside Scotland.

The Convener: Thank you. I am keen to move on to ensure—as I mentioned earlier—that I stick to my own self-denying ordinance. We cannot cover every topic.

I will move on to the topic of quantitative easing, which Professor McCrone raised in his submission, before turning to an issue in Professor McGregor's paper. We had an interesting debate last week—I do not know whether you saw any of it—on quantitative easing and whether it matters in terms of the overall debt because the Treasury does not charge itself interest.

Dr Jim Cuthbert made the point very persuasively—for some of us at least—that quantitative easing should not be included in Scotland's debt figures, and that it currently impacts on the "Government Expenditure and Revenue Scotland" figures when it should not.

What is your view on the issue, Professor McCrone? You discuss it in some detail in your submission, in which you state:

> "How this might affect Scotland's inherited share of the debt is far from clear, but this needs to be taken into account in any negotiations."

Why should it be taken into account?

Professor McCrone: It was Jim Cuthbert's original paper that drew my attention to that very important issue. It is not one that many people understand, and certainly few people have ever talked about it, but roughly 30 per cent of the UK's debt is now held by the Bank of England, and the interest that is paid on that debt is simply returned to the Treasury. In effect, George Osborne is borrowing all that money for no cost at all, so the burden of UK debt is nothing like as bad as it is often made out to be.

If Scotland was going to take a share of UK debt, the negotiators would need to be aware of that, because it is an issue for negotiation. It would be wrong if Scotland took a GDP or population share of UK debt and left the remainder of the UK with all the stuff that the Bank of England holds, on which it is paying nothing. That is an important issue.

I do not know what will happen to that debt in the end—nobody knows. The notion was originally that the Bank of England would simply sell it on the market. If it did so, the Government would have to start paying the interest on the debt, so it would not be very enthusiastic about such a move.

If, on the other hand, the debt just sits there for a long time, one can imagine a situation in which an incoming Government some years hence might say, "What the hell is all this debt doing sitting in the Bank of England? We are not paying any interest on it, so why don't we just cancel it?" That would reduce the UK debt by 30 per cent overnight. It is an important issue, but I do not know how it would be resolved.

Professor Kay: That point goes back to the issue of a monetary union. I think that, if there were a monetary union, the Bank of England would continue exactly as it is and there would be no issue of dividing up its assets and liabilities between the two independent countries.

If, on the other hand, the Bank of England was not to continue as the monetary authority for the entire British isles, the bank would have to be divided up in some sense. That raises the question of what would happen to the various assets and liabilities of the Bank of England, including that debt. That is a real wet towel issue; I could imagine months of discussion and negotiation taking place to resolve that particular question.

To determine the assets and liabilities of a central bank, which has the capacity to print money and has the kind of balance sheet that it does only because it has that power, is very complicated. The key point is right: the national debt is not quite what it seems, because the Bank of England owns almost 40 per cent of it. That must be taken into account as part of the total negotiations on the monetary arrangements for an independent Scotland.

The Convener: I saw that Professor McGregor was nodding vigorously at times.

Professor McGregor: Yes. I have nothing to add, as I agree with the position that that needs to be taken into account in negotiations.

The Convener: If quantitative easing goes ahead, would Scotland's share of the debt as a monetary sum be less?

Professor McGregor: Yes, that is probably the implication.

11:15

Professor McCrone: I think that I am right in saying that—others will correct me if I am wrong—if Scotland were in the European Union and under its rules, it would have to have its own central bank, as is the case in all the European Union countries. However, it is the European Central Bank that has the money creation powers.

Professor Kay: That is right, but a Scottish central bank could be just a man in an office in George Street.

The Convener: I hope that he would be better remunerated than the members of the fiscal commission working group.

The committee is talking about not just the post-independence scenario, but the other side of the coin, which is if Scotland votes no. Professor McGregor, on the second page of your submission you say:

> "Of all the independence and pro-union proposals for further fiscal powers (that are so far in the public domain) the common core is in fact the Labour Party's plans, since these are the most modest to date: all other parties propose plans that are more radical in terms of control over the income tax system as a whole and the set of taxes that will be under Scotland's control."

You go on to discuss what would happen if that plan were implemented. For example, you say:

> "our preliminary analysis of the long-run output and employment effects of setting the SRIT at 15% under conventional bargaining"—

if that happens, which it might not—would result in

> "a 3% fall in GDP, with a slightly smaller fall in employment."

Your paper includes a graph indicating that impact.

Given that the number of people employed in Scotland is around 2.575 million and its GDP is around £140 billion, you are talking about potential job losses of 75,000 and a GDP loss of £4.5 billion. However, you go on to say that if there was a

> "willingness of workers to accept a lower take home wage"

the opposite might be true in that GDP could increase by 1.5 per cent and employment by around 2 per cent or around 50,000.

Will you talk us through your thinking on that particular issue? I found that quite fascinating. Were there to be a level of wage decline as a result of the policy, what would be the equilibrium decline that would provide the additional employment and GDP that is suggested in your figures?

Professor McGregor: First, when I said that the Labour Party plans were the "most modest", it was of those in the public domain—

The Convener: Yes, that is exactly what I mean.

Professor McGregor: I have tried to look at a common core of proposals that would be shared, such as tax powers that are common across a number of the different pro-union parties, as well as the independence party, and look at what the impact of using those powers might be. As far as I am aware, no party in Scotland has yet committed to any radical tax change; indeed, I am not aware of any commitment to do anything other than maintain parity with the UK tax rates. Nonetheless, given that all the proposed powers are quite significant—one may be modest relative to the others but they are all significant—it seems worth exploring what the exercise of those powers would be.

I emphasise in the paper that having and using a power are two quite different things. When using a power, presumably the Scottish Government would want to anticipate what the likely impact of those changes might be. We have explored a simple illustrative case to make a couple of points. When we have a tax rise and an equal increase in Government expenditure, two main countervailing effects are set in motion. On the one hand, there tends to be a stimulus to demand; Government expenditure increases and private consumption declines but, in net terms, demand is stimulated. On the other hand, there tends to be an adverse competitiveness effect because the usual view is that workers bargain for a net-of-tax real wage. If that is the case, as taxes rise, they will push for an increase in nominal wages to compensate them and move them back to a position in which the real wage is maintained.

In general, you cannot predict which of those forces will predominate, but the more open the economy, the more important the adverse competitiveness effects. Scotland is highly open so, in our default model, the net impact is negative and the adverse competitiveness effects outweigh the other effects when bargaining takes place over a net-of-tax real wage. However, if workers were persuaded that they ought to consider the notion of a social wage—that is to say, if unions, for example, valued the services provided by the enhanced Government expenditure—we would have a countervailing effect that could moderate the extent of the competitiveness effect.

The case that we have chosen to illustrate this, which makes the point emphatically, is to suppose that workers felt as well off after the change; that is to say, they valued the Government services as much as they valued their lost disposable income and reflected that in their wage bargains. That would mean that the adverse competitiveness impact would be negated. In fact, there would be no adverse competitiveness effect. In that case, we would get a conventional Keynesian response to a net stimulus to demand and the economy would expand. That would happen, and there would a greater proportion of stimulus to employment, because the real wage had declined. People would accept a reduction in their real take-home pay because they valued the quality of the public services that were provided in exchange for it. That is the mechanism.

It is difficult to tie down the strength of those forces. We have some evidence on attitudes that might suggest that people are a little sceptical about the traditional view that Scots prefer the high-tax, high-expenditure Scandinavian end of the spectrum to the low-tax, low-expenditure Baltic states end of it. However, it seems to matter a great deal in determining the net impact of the fiscal change.

The Convener: What would be the percentage impact on people’s wages?

Professor McGregor: That is a very good point. I cannot remember the precise number. I think that it is in the order of 2 per cent, but I will check it and get back to you. I am sorry, I did not bring the full results of the simulations with me. However, it is a cut in the real take-home pay. The point is that, under the hypothesis, workers feel compensated for that through the quality of the public services that are provided as a consequence. That is why they do not push for a higher wage.

The Convener: Does Professor McCrone or Professor Kay wish to comment on that?

Professor McCrone: I have not done the kind of study that Peter McGregor has done. Because Scotland has been so integrated with the rest of the United Kingdom, the scope for there to be differences in tax without some sort of adverse effect is reduced. The tax rates would constantly be compared across the border in a way that they probably are not between Scandinavian countries—at least, not to the same extent. That would mean that big differences in tax might result in some people shifting—including people that the country does not want to lose, such as entrepreneurs—but small differences would not be any more significant than differences in council tax or non-domestic rates.

Professor Kay: I agree with the thrust of both those observations, because the UK is integrated whatever the constitutional arrangements. Scotland could not have tax rates that were 15 per cent different; it could perhaps have tax rates that were 3 or 5 per cent different, but there are clearly limits to that. If an independent Scotland had different tax rates and if we imagine, as I suspect we mostly do, that it would have a somewhat higher-tax, higher-expenditure base than Scotland does at the moment, a corollary of that—assuming that money does not grow on trees somewhere, which I do not think it does—is that Scots would have rather lower real take-home wages than they do now, whether they bargain for them or not. That is just an inescapable arithmetic outcome. It is the reality of the kind of world that we are describing.

Professor McCrone: It is worth saying that many of the people who comment on such matters in the newspapers argue for a less unequal society—a better provision of social services and all the rest of it. I favour that too, but those people never seem to say much about the tax implications. We cannot have more generous benefits, better social security and a better health service unless we have more tax. Scandinavian taxes are a lot higher than ours at the moment. The question is whether people would accept that. We do not know the answer to that.

The Convener: Surely the issue is that even though Scandinavia has higher tax it also has significantly higher wages, so Scandinavians’ purchasing power is at least as high as that of UK citizens, with the additional services.

Professor McCrone: That is true, of course. The Norwegians will tell you that they do not mind paying higher taxes because they have very good public services—they have said that to me. However, we do not know what the Scottish electorate would think about that. That is the crucial issue.

The Convener: Surely, because they have a higher disposable income, as I just said, as well as better services, the size of the economy and economic growth have to come into play as well.

Professor McCrone: Yes. Economic growth is key to all this. If we can make the Scottish economy grow faster, we can solve all sorts of problems. However, we do not quite know how we can do that at the moment—at least I do not.

The Convener: I had better let committee members in—they are all champing at the bit.

Jamie Hepburn: Professor McCrone, your submission refers to the work by the Institute for Fiscal Studies suggesting that there could be challenges ahead for Scotland. It is an interesting point because, previously, an array of witnesses have suggested to the committee that the IFS paper that you referred to was misunderstood. Professor David Bell told us:

"I think that the IFS report was widely misunderstood in that it was a projection—in other words, it was based on things not changing, in policy terms."

Angus Armstrong stated:

"It is almost inevitable that the projections will not be correct, as they predict the outcome on the basis of current policies".—[*Official Report, Finance Committee*, 4 December 2013; c 3449, 3460.]

Indeed, Professor McGregor was at that meeting and suggested something similar in relation to the IFS's population projections. Do you accept that, essentially, the work of the IFS is predicated on nothing changing?

Professor McCrone: The IFS said that its paper was just arithmetic. It was working out what would happen. There are two important points. The first is that North Sea oil revenues appear to be declining—we are certainly well past the peak of production. We do not really know what future revenues will be. It depends on a whole lot of things such as the price of oil, the cost of getting the oil out and so on. However, the general expectation is that North Sea oil revenues will decline. They have already declined quite a bit, which is why GERS shows that Scotland will be in bigger deficit this year than the UK as a whole. That is the first time for several years that that difference has appeared.

North Sea oil is one point. The other point is the ageing of the Scottish population, which is happening at a faster rate than for the UK as a whole, mainly because we have not had as much immigration as other parts of the UK have had.

We have to take account of those two issues. That is why I think that there would be a challenging situation for an independent Scotland after independence.

Jamie Hepburn: I am sorry, my question was more whether you accept that, in essence, the IFS work was based on nothing particularly changing.

Professor McCrone: The IFS was not making forecasts; it was just doing arithmetic—as it has said—so we cannot treat the IFS paper as a forecast. It does, however, illustrate that there are those two key issues. If we can somehow greatly improve Scotland's economic growth, that could resolve those questions but we do not quite know how that will be done.

As for North Sea oil, there is a good bit of difference between the OBR estimates for North Sea oil in the next few years compared with the Scottish Government's own estimates. The Scottish Government's estimates are now fairly old, so we need new ones.

Jamie Hepburn: Do any of the other witnesses want to comment on that? I know that Professor McGregor said something previously about the IFS.

Professor McGregor: First, I think that the IFS deserves its excellent reputation, but it is the case that these are projections and they are mechanistic. They are comparatively mechanical. The projections make quite a number of assumptions and, if we change those assumptions, we get different results. One of those assumptions is that there will be an unchanged policy stance in some sense. That is potentially significant.

The ageing population issue is particularly difficult because of its dependence on migration. Typically, such population projections are based on very mechanical projections forward of the current population and they are very sensitive to what happens with migration, particularly with regard to the number of people of working age.

Of course, the IFS is aware of that, but the assumptions that we make about such issues are important and they can alter the conclusions of the analysis. None of that is to deny that North Sea oil revenue and ageing are real issues; it is just that the precise combination of those issues and of other things that might be done is difficult to predict.

11:30

Jamie Hepburn: Professor McCrone, you have provided us with a very useful submission. You were also the author of what is now a fairly well-known report for the United Kingdom Government from back in the 1970s, in which you said that Scotland would

"tend to be in chronic surplus to a quite embarrassing degree".

Denis Healey, who was the chancellor when that report was circulating in Whitehall, told Holyrood magazine recently that the UK Government

"did underplay the value of the oil to the country".

Just last week, Jim Cuthbert highlighted Cabinet minutes from 15 December 1977 in which an oil fund was discounted for those very reasons. Given that the value of the oil was underplayed in the past and that people were not told by the UK Government that an independent Scotland would

"tend to be in chronic surplus to a quite embarrassing degree",

what might the people of Scotland not be getting told now?

Professor McCrone: I was being what I thought was honest in 1974. Various people have said that the paper was hushed up and should have been published. In that connection, it is quite interesting that Sir Nicholas Macpherson has recently been getting into trouble for publishing his paper. It is a fact that briefings for ministers are not normally published. If I had published the paper, I suspect that I would have been kicked out of the civil service pretty sharply, because civil servants do not publish their submissions to ministers. Ministers in the Scottish Government will find exactly the same thing. That is the first point.

The second point is that there was, of course, an enormous expectation of huge oil revenues in the early 1980s. I wrote that paper in 1974 and had forgotten that I had written it until somebody unearthed it through the usual method of getting stuff out of secret information. When I read it again, I did not think that there was anything wrong with it. In fact, the oil revenues that I predicted were slightly lower than those that occurred. I said that I thought that the figure would be around £3 billion in 1980; it was £3.7 billion in 1980-81.

The output figures were the ones that everybody knew at the time. They had already been published by the Department of Trade and Industry. It was simply a matter to trying to calculate what the revenues ought to be, based on that output. That was quite difficult, because the Conservative Government had not put in place appropriate tax measures by the time that it left office, so it remained for the Labour Government to introduce petroleum revenue tax. It set up the British National Oil Corporation to do all the other things that it did in order to ensure that the country got a decent share of the revenue and that all the revenue did not just go to private shareholders sitting in America or wherever. Therefore, the calculation was fairly uncertain, but I am rather pleased that I managed to calculate the revenues as accurately as I did for 1980.

The situation now is completely different. At present-day prices, there was around £30 billion of oil revenues at that time. In the prices of the day, the figure was £12 billion, but in real terms it is around £30 billion. The revenues were therefore huge and, if Scotland had been independent, they would of course have had a profound effect on the whole situation here. In fact, one of the problems would have been what the hell to do with them, because they would have pushed up the exchange rate and put the rest of industry out of business if people had not been careful. That is why the Norwegians set up their oil fund and why their oil fund invests abroad—to try to help control the pressure on the exchange rate.

There are many issues, but my paper has become rather notorious because it was released under freedom of information. However, that was the situation then; it is not the situation now.

Jamie Hepburn: I accept that. I am not saying that anything was wrong with your report, and I am not suggesting that it was your responsibility as a civil servant at the time to release that information. The point that I am making is that it informed the UK Government of the actual position and the UK Government took the decision not to impart that information. That begets the question: is that happening now? To be fair, that might not be a question that you can answer with any certainty—in fact, it almost certainly is not. The only way that we will find out whether that is happening now is if that information is released 30 years hence. You have referred to an opportunity missed back then; there could be an opportunity missed now.

Professor McCrone: Obviously I do not know, but I do not believe that anything is being hushed up now. I do not think that things were actually hushed up then; it is just that that paper was not published.

Jamie Hepburn: I am not sure that I would entirely agree with that.

Professor McCrone: I might just add that I wrote a second paper, which has not been unearthed yet, in which I recommended an oil fund, among other things.

Jamie Hepburn: We will start looking for that one. Thanks for the heads-up. [*Laughter*.]

Professor McGregor, you start your submission by saying that

"the outcome of the referendum is, of course, uncertain",

which is a matter of fact. You go on to say that

"it seems clear that future Scottish Governments will possess substantially enhanced tax powers relative to the current position",

and you refer to the Scotland Act 2012. You also say:

"all of the pro-union bodies proposals for further devolution in the event of a 'no' vote that are in the public domain imply significant additional powers."

We know that, if we get a yes vote on 18 September 2014, Scotland will go on to become an independent, sovereign state. If we vote no, there is no guarantee that additional powers will come to Scotland; indeed there is precedent to consider—for example, Alec Douglas-Home telling us to vote no in 1979 for enhanced devolution that did not happen. More recently, the Calman commission proposed more significant powers than were delivered by the Scotland Act 2012. Would you accept that there is no guarantee of additional powers if we vote no?

Professor McGregor: The only absolute guarantee is that there will be additional fiscal powers because of the Scotland Act 2012. That is the only decision that it is certain will be implemented, which is why I have considered that as illustrative of the common core. The Labour Party's proposals go rather further than the act, but the act is the irreducible common core because it has already been decided. Everything else is uncertain.

What my analysis does is to give a flavour of the types of impacts that could arise if the powers are actually used. As far as I am aware, no one has committed yet to varying the Scottish rate of income tax from the rate in the rest of the UK.

Jamie Hepburn: I understand that point. The only thing that we know thus far is that the Scotland Act 2012 has been passed and the powers that are set out therein. However, we know that, if we vote yes in the referendum, we will become an independent state. If we vote no, we do not know whether those additional powers will come to Scotland. There is no guarantee.

Professor McGregor: There is no guarantee. That is correct.

Jamie Hepburn: You said in your submission:

> "Under all of the pro-union plans that are in the public domain, the Scottish Parliament would have comparatively limited influence on the overall fiscal policy stance".

What might be the consequences of that limited influence, from your perspective?

Professor McGregor: I believe that that is true—to different degrees, I should emphasise—of any of the proposals for constitutional change, including independence. Of course, it is less true of independence than of the other proposals.

We went through the arguments earlier about an independent Scotland that has monetary union with the rest of the UK, and Professor Kay reminded us of the importance of the Bank of England and its undoubted attempts to influence the fiscal policy stance in Scotland. I would say that all of the current proposals for constitutional change, including independence, imply a degree of restriction on the overall fiscal policy stance. However, I would accept that the extent of restriction will vary among the proposals and would be least in the case of independence. I am not sure by how much, though. That would depend.

Jamie Hepburn: What might be the restrictions in the case of the other proposals?

Professor McGregor: There are borrowing proposals in the Scotland Act 2012, which is important. Those proposals are focused on capital expenditure, which is important as well. However, I do not think that the pro-union proposals imply any great measure of control over the aggregate fiscal stance in terms of the difference between Government expenditure and taxation and the ability to run deficit-financed expansions, for example.

Professor McCrone: That is right. The big difference is that an independent Scotland would have to have regard to what its budget was and to keep the deficit under control. The general rule that the European Union has is that the deficit should be less than 3 per cent of GDP. There is no requirement in the case of regions in a country—which is what Scotland will be, economically anyhow, if the no vote prevails—to have any particular balance in their budget.

The idea is that expenditure should in some way be related to need and that taxation should be related to taxable capacity. For example, in Northern Ireland, there is a lower taxable capacity and a higher level of public expenditure. In Wales, there is a lower level of taxable capacity but a smaller level of public expenditure than in Scotland, although the overall deficit in Wales is probably larger than it is in Scotland because the taxable capacity is less. You can go round the various regions, although the figures are not very adequate now. The northern region is probably in much the same position as Wales. London has a higher level of public expenditure than any of the English regions and it is more similar to the level of public expenditure in Scotland, but it also has very high tax revenue.

Malcolm Chisholm: I was very interested in Professor Kay's comment that he does not think that there will be a monetary union because the very tight fiscal controls that would be required would not be acceptable to the Scottish Government. That reminded me of what I thought was a key point of Sir Nicholas Macpherson's note when he said that the fiscal controls would be too tight. Assuming for the purposes of this question that there will not be a monetary union—although I assume it anyway—I am really interested in the possible consequences.

I am not sure whether Professor McCrone wants monetary union because it is the best scenario or whether he is saying that it will happen anyway because of the markets. For whatever reason, if it is going to happen, I am interested in the consequences, but they are not being spelt out to any great extent in the current debate. You mentioned the transaction costs, which are well known, but what would the effect be on interest rates and on any other economic and financial aspects?

Professor McCrone: Whether or not there is monetary union, there will be separate Scottish debt. That will probably be at a slightly higher rate of interest than UK debt, for the simple reason that the UK has a long record of not defaulting on its debt. Scotland has no such record—unless we go back to the Darien scheme, and that is something that we all want to forget. Scotland would therefore have to establish itself as a credible borrower because it would be a much smaller participant in the market. For all those reasons, I would expect the interest rate on Scottish debt to be a bit higher than it would be for the UK as a whole. That is particularly the case if there is independence.

With monetary union, that would still happen. It would probably be reflected in things like mortgage rates and various other rates across the economy. How big would that difference be? We do not know, but I think that the National Institute of Economic and Social Research has suggested a figure between 0.6 and 1.8 per cent of GDP. It would be quite significant, although we could cope with it. It does mean that, if you have to pay more interest on your accumulated debt, it affects your budgetary situation and your budget deficit is bigger than it would otherwise be.

Malcolm Chisholm: What would be the additional interest rates if there was not a monetary union, assuming that there would be some? If there are no extra negatives, apart from transaction costs, to not having monetary union, it is not quite clear to me why the Scottish Government should be so adamant that there must be a monetary union.

Professor McCrone: If there is a monetary union, it makes all those things a bit easier. If there is no monetary union, there is more of a risk that the exchange rate might be altered either by force or by design at some stage. If the market thinks that there could be a change in the exchange rate, it tends to be reflected in interest rates, so you tend to get a bigger difference in interest rates.

On the whole, a separate currency that is pegged to sterling is probably the best answer in the long run. That is what the Irish did for a long time, and then they unpegged their currency when they went into the European exchange rate mechanism.

Small countries often do that. The Danes have kept their own currency but it is pegged to the euro, and that means that they can alter it if they really have to. The pressures on Scotland's balance of payments would be rather different from that of the UK as a whole because of the oil. If the oil price went up, the pressure would be to lift the Scottish exchange rate. If the oil price dropped dramatically, the tendency would be to push the balance of payments into deficit and that would tend to be reflected in the exchange rate. Although the two economies are similar in many respects, the oil means that there is one big difference between them.

Malcolm Chisholm: Do the other two professors agree with the comments on interest rates?

11:45

Professor Kay: No, I do not altogether. I think that all of this is rather complicated.

We need to talk first about what scenarios we are looking at. Professor McCrone talked about pegs, and he mentioned Ireland and Denmark, but they are different. In the case of Denmark, there has always been the Danish krone, which is now fixed or pegged at, I think, 7.5 kroner to the euro. In the Irish case, back in 1921 or 1922 when Ireland became independent it did not peg the Irish pound to the pound sterling; it did nothing at all. Things continued just as if political independence in Ireland had never happened. Private commercial Irish banks issued notes that circulated in Ireland and Northern Ireland, but not in the UK, that were like current Scottish banknotes, which are backed by the English pound. There was not even an Irish currency board until the late 1920s, at which time the Irish Government started issuing Irish banknotes. However, they were backed at that time by Bank of England notes. It was not until 1941 or 1942 that Ireland set up its own central bank.

We do not have quite the leisurely pace today that characterised Ireland and the global financial markets then. However, there are a lot of variants on the possible options. That does not answer your question, but I think that it gives a relevant background for it.

Malcolm Chisholm: That is helpful. Thank you.

Jamie Hepburn referred to the Institute for Fiscal Studies looking far into the future. That clearly has its difficulties, but I want to concentrate on the immediate post-independence period if there is a yes vote. What is your assessment of what the fiscal situation would be for an independent Scotland? Our witnesses last week tended to say that it would be more fiscally challenging than the situation that the rest of the UK would face. Professor McCrone, what is your assessment of the fiscal situation facing an independent Scotland in 2016?

Professor McCrone: I think that it would be more challenging because the figures already show that the deficit in Scotland is slightly larger than that for the rest of UK as a whole: 8.3 per cent compared with 7.3 per cent of GDP. If oil revenues go on declining, that is a pressure that will make the situation worse.

I think that there would be a fiscally challenging situation for an independent Scotland because a lot of promises have been made and some of them will be quite expensive. I do not see that the revenue would be there to match all those promises, so I think that there would be quite a tough situation.

Malcolm Chisholm: Do you have any comment, Professor McGregor?

Professor McGregor: I broadly agree with that answer: it looks likely that the post-independence situation would be more challenging. However, public sector deficits are notoriously difficult to predict accurately because of the difference between two very big numbers, and they depend on what is happening with a whole load of other things in the economy.

It is difficult to predict, but present evidence indicates that the post-independence situation is likely to be more challenging. That is not to say that policies pursued by an independent Scottish Government that were successful would not generate more economic growth. There is a puzzle as to how exactly growth would be generated, but if Scotland was successful in doing that, it could grow its way out of a fiscal problem.

Malcolm Chisholm: I accept that in principle, but obviously that would take a year or two. I want to concentrate on the immediate post-independence period.

My final question is to Professor McCrone. In both your book and your paper you talk about options for further fiscal devolution. I am particularly interested in why, although you are a supporter of further devolution of control over income tax, you are not in favour of that control being completely devolved to the Scottish Parliament. I am interested in your thinking about that.

That is what my primary question is about, although another proposal of yours is also of interest. My secondary question concerns why you are keen on the assignment of VAT revenues, but my main interest is in the income tax question.

Professor McCrone: I have thought quite a lot about the income tax issue. A number of people have suggested that the whole of income tax should be devolved. The trouble with that is that it would leave the UK Government with taxes that are mainly regressive. If the UK Government then had to raise more money all of a sudden—because of some disaster or a war, for example—it could raise VAT but it would be unable to put up income tax.

I think that there ought to be some tax available to the UK Government that is progressive, not regressive. In this recession, I would not have put up VAT; I would have put something extra on income tax, because that would have hit the poorer people less hard. That is the main reason why I shied away from advocating the devolution of the whole of income tax.

Various people have told me that assigning the revenue from VAT is pointless. For various reasons, I do not think that that is true. Obviously, you cannot alter the rate of VAT within one country, as that is against EU rules, but in a situation in which VAT is assigned, if the Scottish Government is successful in generating more economic growth, it will get more taxation revenue. A lot of the people who have argued in favour of giving Scotland more tax powers have said that the Government needs to have the ability to get additional tax revenues if it is successful in promoting growth. We would get that if we assigned VAT. That seems to me quite important.

The other point is that, in England, there is a fair amount of pressure with regard to the view that Scotland gets more public expenditure than it deserves and the Barnett formula is too generous—all of that kind of thing. Although nobody has made a commitment in that regard, someone will eventually have to examine the situation again—I do not know when, but sometime in the future.

The pressure in that regard would be a bit reduced if Scotland were seen to be raising more of its own money from taxation, so that the block grant would be considerably smaller. Those are the two main reasons I recommended those things.

Malcolm Chisholm: That is helpful. Thank you.

Jean Urquhart: I have had many questions in my head since we started this discussion, but I would like to ask you about the current economy of the United Kingdom. There seems to be an implication that everything is okay as it is, and that we should not upset the apple cart. However, many economists and others feel that everything is not okay and that, actually, Scotland could make a much better stab at things.

Earlier today, we were looking at the OBR's forecast. On house prices in Scotland, it says that

"although property transactions have picked up recently, they remain well below their long-run trend".

All of that suggests a scenario in which things will get back to normal after we have paid off a debt. To a lot of people, that approach seems likely to lead us headlong straight back into the extraordinary economic mess that we are currently struggling to get out of. My question to you is, how do we effect change, from a Scottish perspective, without actually changing something?

Professor McCrone: You will probably get different answers from all three of us on that question.

I rather agree with what you have said. Many people misunderstand the situation that we got into with the financial crash. The main problem was not with Government debt. Levels of Government debt perhaps should have been a bit lower than they were, and the Chancellors of the Exchequer in the Labour Government should not have been budgeting for a surplus when they had a deficit of 3 or 4 per cent, but the deficit was not the problem. The problem was with private debt, which escalated more and more until, eventually, it could escalate no further and the thing collapsed. That turns into Government debt, because the Government finds that its tax revenue is reduced and its expenditure on things such as unemployment benefit has gone up, which means that Government debt goes up. However, that was a consequence of what happened, rather than a result of any adverse planning by the Government itself.

Are we heading for the same situation again? I am worried about what is happening in the housing market. House prices in Britain are probably too high anyway. Countries such as Germany, where there is a much smaller owner-occupied sector and a much better and bigger social rented sector, are at an advantage, because they do not get themselves into that pickle.

There is a danger that we will fall into the same trap again. Usually, the best way out of such a recession is for the exchange rates to go down and exports to improve, as they did in the early 1990s, but it would be difficult to get exports to improve even if the exchange rate were to go down at the moment, because the markets to which we export are also depressed. That is the main difficulty. The eurozone is in quite as much trouble as we are. I am a bit worried that we have not learned the lessons and that we will get back into the same pickle that we were in before. It is difficult to say how a Scottish Government would deal with that, but I would like a considerable change to be made to housing policy.

Professor Kay: We have a global financial sector and system that is set up to generate endemic financial crises. What we saw in 2008 was simply one of a series that I expect to continue. The UK Government’s capacity to do much about that unilaterally is limited; the capacity of a Scottish Government to do something about it is a good deal smaller. The best that a UK or a Scottish Government can do is determine what small steps it can take to insulate the UK or the Scottish economy from the consequences, but the capacity to do that is also quite limited.

Professor McCrone: We need to accept that in any society—even the richest—the distribution of income is such that the poor people in that society cannot afford the full economic cost of their housing and that encouraging people to buy housing when they cannot really afford it is one of the problems that has arisen. That is why I like the situation in Scandinavia and Germany, where there is a decent provision of social rented housing and less emphasis on encouraging people to buy houses when they cannot really afford it.

Jean Urquhart: The implication of that is that it would be a good idea for Scotland to govern itself.

Professor McCrone: A Scottish Government could certainly do something about that if Scotland were independent. It could also move in that direction if it were simply given more devolved powers.

Professor Kay: More should be spent on social housing. We can take the constitutional implications of that any way we like.

Professor McGregor: It clearly depends on the extent to which you judge the set of problems that the UK is currently experiencing to be a function of UK policy or a function of events in the rest of the world, Ms Urquhart. It is absolutely right that rest-of-the-world events are crucial and are basically exogenous to the UK, as they are to Scotland. Scotland can do its best to insulate itself against them, but I agree that there is not a fantastic amount that it can do.

If you judge that, in addition to the world forces, the UK Government has behaved in a manner that has made things worse, you might use that to make an argument for Scotland having greater fiscal powers and, ultimately, independence, but it is rather difficult to do that, although I can see that the policies that the chancellor pursued are controversial. The UK economy is in recovery, but it is a modest one and some would argue that the counterfactual is that it might have recovered rather more rapidly had a different set of macroeconomic policies been implemented. It depends critically on the point on that spectrum that you judge to be appropriate.

Jean Urquhart: I have a question on Standard Life, which has had much publicity, and other incorporated companies that are supposedly threatening to leave Scotland in the event of independence. It seems to me that the annual report of every incorporated company has to highlight its risks.

The risk that is highlighted in, for example, Standard Life's annual report seems very nominal compared with the publicity that is generated about that risk. I know that the issue has already come up, but I presume that no company would be in a rush to leave Scotland until it better understood what was meant by independence, all of which would be down to the negotiated settlement and the nation's political philosophy.

12:00

Professor McCrone: Yes, I think that that is right. What companies do will depend on what their clients want them to do. If Standard Life felt that, given that the majority of its clients are not in Scotland, it would do better, get more clients and satisfy the ones that it has by moving part of its operation to England, that is what it would do. It would determine its position on that basis.

I am less sure whether any action would need to be taken by the fund managers—the people who run the investment trusts and suchlike—but clients in England might ask why they should put their money in a company that was in a foreign country rather than in one in their own country. That is the issue.

Jean Urquhart: Are you seriously suggesting that everyone who is a Standard Life customer thinks in those terms?

Professor McCrone: It is possible that such thinking could affect Standard Life's ability to get new customers. People who place an insurance policy with a company just want to consider what the risks are. If they think that a degree of risk exists because they would be placing their insurance policy with a company in a foreign country, such as Germany or France, they would not do that. Most of those people invest in their own country for that reason. The question is whether independence would have a significant effect in that regard. That will depend very much on what happens and we cannot predict that in advance.

Professor McGregor: A critical factor would be the judgment about the likelihood of maintaining the monetary union. Were there to be a lack of confidence around that, the risk would increase and the incentive to move might be higher.

Professor Kay: This argument is very strange, because people do not know the specifics of what they are talking about. Everyone in this room has a bank account. Those accounts will be with various banks—some of them will be UK banks, but one of them is, ultimately, a Spanish bank and another is, ultimately, an Australian bank. If you went into any branch of those banks and asked the people behind the desk the questions, "What is the regulated entity with which I am trading?", "Under what law am I making a contract with the bank when I place a deposit?" and "What provisions could the Scottish Government or the UK Government make to change the terms of my contract?", they would not have the slightest idea how to answer. Indeed, you could go to a top Scottish Queen's counsel and he would struggle to give you answers to those questions and the answers that he would give would be very long.

Those are the questions that are relevant to the risks that people are taking and how those risks would change were there to be independence. Those risks depend on what the regulated entity is and where the contract is made. The answers to all those questions are rather obscure. If Scotland became independent, those matters would be sorted out in ways that were sensible for all parties. Everyone who thinks about it knows that that is the answer to the question. Such fears are, essentially, imaginary. To investigate what they are is almost impractical, but that does not mean that people may not genuinely hold such vague, ill-formulated concerns; it is plain in talking to people that they do. It is simply the case that any threatened change creates unease and uncertainty. I cannot see that there is any specific material basis for that.

Jean Urquhart: My final question is very short. The economic scenario that is painted in various reports is based on the status quo across the UK. The percentages for expenditure on defence and so on are based roughly on what is being done, but that is only one side of the balance sheet; we have to look at the other side.

Is it not the case that, in an independent Scotland, which would have its own set of priorities, some of those budgets would change quite dramatically?

Professor McCrone: Are you suggesting that, because of independence, the rate of economic growth would be different—higher, for example?

Jean Urquhart: It could be. I am looking at the expenditure. We are talking mostly about the collection of tax and the ability of the country to pay its tax and so on, but there are British Government expenditures—aside from the expenditure on public services such as health and education that everybody expects—that Scotland might choose not to make. Expenditure on defence is the obvious example, but there are many other sections of the balance sheet for UK plc that Scotland plc might choose to change.

Professor McCrone: The Treasury produces its identifiable expenditure figures, which leave out of account things such as foreign embassies, defence and interest on the national debt, as those are not capable, at present, of being allocated to particular parts of the United Kingdom. Those elements make up much the smaller part of the budget, but it would be possible for Scotland to take different decisions on them. That is most obviously the case on defence.

On foreign embassies, I would expect that the cost might go up rather than down, because Scotland would want foreign embassies all over the place. Although it might not want as many as the UK has, it might want to have a number comparable to the number that Ireland has.

The other area that is not very much devolved is social security and welfare. In my submission, I suggested that there would be scope for devolving quite a lot of what the Department for Work and Pensions does. We would probably not want to devolve all of it, because I think that we would want to retain the same level of old-age pension—which is the main element, being nearly half of the DWP's expenditure—throughout the UK, but a lot of other benefits could perfectly well be devolved. If Scotland were independent, it might take a different view on all those things, its rate of old-age pension might be higher or lower and the way in which it dealt with benefits might be quite different.

I would expect that, over time, the tax system and the expenditure side would both change dramatically. There is a need to reform the tax system, as it is pretty anomalous at the moment. Sir James Mirrlees, who is a Scot and a Nobel prize winner in economics, has produced an enormous report that makes recommendations on the future of the tax system—a report that, incidentally, I have not read, because it is so long.

It is clear that an independent Scotland would want to look at that sort of thing with a view to coming up with a more practical and less anomalous system. All that would take time, but it might result in quite a lot of differences in the long run.

Professor McGregor: One of the big arguments in favour of fiscal devolution or decentralisation is the idea that we bring decisions closer to the people who are affected by them. There are undoubted benefits in doing that but, traditionally, there are acknowledged to be areas in which the cost of doing so might be rather more significant. We just heard an example: defence and foreign affairs are areas that are typically emphasised in that regard. There might be some loss of efficiency as a consequence but, nonetheless, such a change would undoubtedly bring decisions closer to the people who are directly affected by them.

Michael McMahon: Going back to our earlier discussion about the capacity to grow the economy and how we would do so, I do not think that any of you have suggested how that would be possible. The Scottish Government's white paper, which I am reliably informed has the answers to everything, suggests that a 3 per cent cut in corporation tax would grow the economy. Some people have analysed that, and Professor Stiglitz is among a number of people who have said that the suggestion is not quite as straightforward as it would appear in the white paper. Do you have any comments on that?

We have also had Professor Hughes Hallett and Crawford Beveridge in front of us suggesting that the margin of difference would have to be much more radical than 3 per cent to make any difference. Do you agree with that analysis?

Professor McCrone: It is rather difficult to say. As far as I can see, the two measures in the white paper on how an independent Scotland would grow the economy are, first, a lower rate of corporation tax and, secondly, the use of childcare to free up more of the labour market to take jobs. Of course, the latter depends on the jobs actually being there. If Scotland was able to generate more jobs, people would, as happened in Ireland, automatically come in from outside.

What happened in Ireland has given people the idea that a lower rate of corporation tax is the answer to all of this, but I think that there are various problems with that. When Ireland joined the European Union it was by quite a long way the poorest member state, and nobody raised much objection to the fact that its rate of corporation tax was very low. As far as I can recall, at the time Ireland did not have corporation tax for businesses that dealt only in exports, and the tax was only on businesses that dealt in the home territory. It was obliged to change that, but, when it did so, it brought in a corporation tax of 12.5 per cent, which was about half of that in most other countries. That resulted in a lot of companies looking at Ireland that would not otherwise have done so—and, incidentally, also resulted in a lot of businesses declaring their tax in Ireland without actually employing many people there. We have had the same problem throughout the world with companies such as Google and Starbucks trying to declare their profits in areas where the taxes are lowest, which has adversely affected the UK and various other countries.

If an independent Scotland reduced the level of corporation tax, it would probably generate more economic activity and would also result in businesses wanting to declare their taxes in Scotland rather than in the rest of the UK. That would mean that, if there were a negotiation on monetary union, the rest of the UK would insist that there was no discriminatory tax that could attract business to Scotland that might otherwise go to, for instance, the north of England, which I think would be up in arms otherwise. I therefore think that it would be very difficult for an independent Scotland in a currency union with the rest of the UK to have a different rate of corporation tax. I might be wrong about that, but that is what I think.

There is also the question of the European Union. It has been trying like anything to get the Irish to raise their corporation tax, but they have so far managed to resist. However, as the eurozone develops, it is possible that taxes will be much more harmonised across the countries in it, so the Irish might eventually have to give up their lower rate of corporation tax.

Corporation tax is a difficult issue, but it seems to me to be fraught with all sorts of problems if Scotland wanted to remain in a monetary union with the rest of the UK or wanted to join the European Union.

Professor Kay: I completely agree with Professor McCrone. The strategy of having a much lower rate of corporation tax—we are talking not about a 3 per cent difference, but about a much bigger one—was successful for Ireland in attracting economic activity and tax revenue, both of which came almost entirely at the expense of European countries. The very success of that policy for Ireland means that other countries are not going to be allowed to do it—that would be the practical reality of any negotiation. Scotland would have to have extended negotiations with both the rest of the UK and the EU over independence. I therefore think that believing that Scotland would get economic growth from lowering corporation tax is chimerical.

Professor McCrone: It is now more than 20 years since I left the Scottish Office. I was there for 22 years, and I spent most of my time trying to encourage economic growth in Scotland—that was my main objective. I was one of the architects of the regional policy that was introduced in the 1980s, and I greatly regretted the fact that, during the years of the Conservative Government, many of the regional policy measures were removed, which greatly weakened the policy.

By setting up the Scottish Development Agency—or what is now Scottish Enterprise—we managed to preserve that approach during the 1980s, but only just. I think that the problem now throughout the United Kingdom is an increasing imbalance between the economy in the south-east of England and the economy in the rest of the UK, and that badly needs to be addressed with some measure. I do not know whether that would mean bringing back a stronger regional policy but that is the kind of measure that needs to be pursued.

12:15

For a variety of reasons, partly to do with North Sea oil and partly to do with the financial sector, Scotland has done much better than other parts of the UK. In terms of GDP per head, we have more or less caught up with the rest of the UK, and we are now about 2 per cent below the UK average. Places such as Wales, the north of England and other parts of England have done much less well. The priority, therefore, is not quite as great in Scotland as it is elsewhere. Nevertheless, whether Scotland remains part of the UK or becomes independent, we badly need to think about how we deal with the balance of the economy in these islands. The south-east of England, and London in particular, will go on being a magnet unless something is done about it.

Professor McGregor: I agree with the point about regional policy and regional policy activism.

That aside, though, I should say that when colleagues in the Fraser of Allander Institute and I explored the impact of a 3 per cent cut in corporation tax, our work reaffirmed Professor McCrone's intuition, because we found that, eventually, such a move would have a small stimulating effect on the Scottish economy. However, there were perhaps two qualifications. First, we assumed that there would be no reaction whatever with regard to corporation tax rates elsewhere in the UK. It was around the time of the negotiations with Northern Ireland on an agreed and negotiated reduction in corporation tax, and we looked at the implications of that kind of scenario. There was no gaming around the setting of taxes, which, in practice, made the analysis a great deal simpler. However, as has already been said, that would be a major issue.

Although in this particular case we did not explicitly analyse the impact on the rest of the UK, it is correct to say that there would almost certainly be negative spillover effects for the rest of the UK. However, under those restricted circumstances, it looked as if corporation tax cuts could eventually be effective in stimulating activity.

Michael McMahon: Professor McCrone also mentioned the childcare initiative. We have discovered that the Scottish Government has not modelled any projections in that respect and that its figures in the white paper are, at best, speculative. Have you done any gaming with or modelling of the figures in the white paper?

Professor McGregor: No. The childcare proposals are an area to which we would like to turn our attention but we have not been able to do so yet. Although such supply-side policies are known to be able to generate significant effects, you need to be very careful about the specification, the transmission mechanisms and the link to the wider economy. That is a challenge in itself. However, we are certainly interested in looking at the proposals in more detail.

Michael McMahon: I have one more question on how we analyse the figures. A report in yesterday's newspapers suggested that a German bank, Commerzbank, had looked at the figures being used to illustrate Scotland's economic performance and had identified that, too often, we are comparing apples and oranges. For example, the Scottish Government has used tax receipts as a per capita figure but when it looks at public expenditure, it has used the figures as a share of GDP. However, when we carry out a proper comparison of the figures on a per capita basis, we find that the figures used in the Scottish Government's analysis indicate that spending is 10 per cent higher in Scotland than is shown by the figures produced by the Scottish Government. Are you familiar with that type of statistical manipulation?

Professor McGregor: Not directly. It is undeniable that spending per capita in Scotland is significantly higher. However, I cannot comment on the report that you have highlighted because I did not read that particular analysis and do not have the data at my fingertips.

All that I would say is that this kind of debate—if that is what this is—and concern about the accuracy of data that is provided by the Government are precisely why there is a good case for establishing a fiscal commission and having independent analysis of statements made by any party or Government of the day. I cannot comment on the specifics of this particular case, but I think that the issue itself indicates the need for that kind of independent analysis.

Michael McMahon: I agree with you on that point.

Professor McCrone: It is well known that Scottish public expenditure per head is higher than the UK average by about 10 per cent. We also know that onshore tax revenue, excluding North Sea oil, is about equal to the UK average. That creates a gap that North Sea oil revenues would be required to fill; they would not fill it completely, but they would go a long way towards doing so.

That is the essence of the budgetary problem. Somebody asked earlier whether things would be more challenging if Scotland was independent, and the fact is that this issue would have to be dealt with. If Scotland's public expenditure was similar to the UK average, North Sea oil would be a kind of bonus, which would be all right. However, Scotland's public expenditure is about 10 per cent higher than the UK average.

Nobody really knows whether that level of public expenditure is justified. It has been like that for absolutely ages; the Macmillan Government deliberately raised it in Scotland and the north of England in the 1960s to try to deal with the then higher levels of unemployment, and since then we have tended to have a higher level of public expenditure per head. Is that justified? No needs assessment has been done, other than a rather scrappy one by the Treasury in the 1970s, and no one will be able to decide whether that higher level of public expenditure is justified until that analysis is carried out.

Gavin Brown: You might have caught the tail end of the earlier part of this morning's meeting, in which we had a discussion about the Scottish rate of income tax and the estimated £35 million in transition costs. Have our panellists looked at the transition costs for Scotland if Scotland were to vote yes to independence in September? What transition costs would we be talking about? Are you aware of any analysis of that?

Professor McCrone: I have not looked at that, but it is pretty obvious that there would be substantial costs in setting up an entirely new tax system and a lot of institutions that are currently UK based. There will certainly be transition costs, but I cannot put a figure on them and I do not know whether any of my colleagues can.

Professor McGregor: I cannot either. There are some relevant pieces of analysis, such as attempts to measure the scale of the risk premium that would be associated with Scottish Government debt, and other individual pieces of analysis. However, I am not aware of analysis that covers the whole issue, so I really have no idea of what the figure would be.

Professor Kay: I, too, do not think that any work has been done on that; I am certainly not aware of any. An implicit theme that has emerged at various times during this morning's meeting is that the number of complicated details that have to be sorted out is extremely large and that, at the moment, almost nobody knows how many of them there are. They are problems that arise only when you start to think about the issue.

Gavin Brown: We have touched on the overall fiscal situation a couple of times during questions. At one end of the scale, the Institute for Fiscal Studies published 50-year projections and, at the other, the white paper has projections for one year—2016-17. Do panellists have a view on the level of detail and for how many years forecasts should be published, either by Governments or independently, so that people who are looking at the issue sensibly can get a reasonable sense of what the situation would be, were Scotland to become independent? I know that there are many unknowns.

Professor McCrone: One of the things that you must know about economic statistics is that forecasts are always wrong. They are a bit better than the weather forecasts, but not much, and the further out they go, the more wrong they usually are.

I would like to see five-year forecasts, but they have to be treated with a lot of caution because all kinds of things can happen. Nobody—or very few people—saw the financial crisis arising. It hit us in 2008 and knocked everything skew-whiff. The UK Government forecasts proved to be completely wrong. It is nearly always the case that economic forecasts, whatever they are, are not quite right.

Professor Kay: Such exercises, however, are done not because people believe that the forecasts in them will come true, but because the forecasts provide information that illuminates policy decisions. For example, the IFS work brings home the fact that Scotland has two particular issues—declining North Sea oil revenues and a relatively unfavourable demographic situation. In looking at those issues over 50 years, one is not saying, “This is what is going to happen over the next 50 years.” It is simply an arithmetical way of identifying issues in order to illuminate the debate and the policy decisions that we make.

Professor McGregor: I completely agree with that. In terms of forecasts, we should think at least in terms of the lifetime of a Government; a five-year period seems to be perfectly reasonable.

People should understand that of course forecasts may be wrong because we cannot foresee the future, but that is not the point. Forecasts are conditional and are understood to be conditional, but they inform us about a likely future and they provide us with a modelling framework that allows us to explore the potential impact of policies. It seems to me that that should be an essential part of the policy formation process.

The projections that the IFS has produced for the longer term are understood in a rather different way and are for a different purpose. They are valuable, provided that they are interpreted with caution, in that they are very useful in drawing our attention to potential problem areas. There is a challenge for policy to respond to, in solving problems.

The panoply of shorter-term forecasts and longer-term projections are useful inputs to the information set that the public and the Government can use to assess the quality of the policy decisions that are being made.

Gavin Brown: Just in passing, Professor McCrone said that nobody saw that the banking crisis was going to happen but—

Professor McCrone: About two people saw it coming.

Gavin Brown: The number of people who now say that they saw the crisis coming is amazing. The numbers do not quite match up. That is just a detail.

Professor McCrone talked about the rate of interest on borrowing that a Scottish Government would have to pay. Can you expand on what you think the difference in the rate of interest might be between what the Scottish Government would pay and what the UK Government currently pays?

You also said that that difference would transfer in some way to mortgages in Scotland. Can you expand on how it would transfer and what the effect might be?

Professor McCrone: It is now fairly widely accepted that if Scotland becomes independent, the rate of interest on its debt would likely be a bit higher than the rate of interest on UK debt because Scotland would be a new borrower. It does not have a track record of no defaults since the reign of Charles II, which is what the UK has. For that reason, and also because Scotland will be a fairly small borrower, the rate of interest would likely be a bit higher. The IFS has put a range of figures on this. I cannot remember the figures exactly—the figures are between 0.6 per cent higher and 1.8 per cent higher, or something of that kind. I do not know what the rate would be, but we have to assume that the rate of interest on Scottish debt would probably be about 1 per cent higher, which would have quite a big effect on the cost of the debt.

Why would that affect mortgages and so on? If the rate at which the Government is borrowing is higher, it tends to be reflected right through the financial system, so there would probably be higher interest rates on mortgages as well. Of course, there is a bit of a problem with mortgages. If Scotland had a separate currency, or was at all likely to have a separate currency, it would be rather foolish for people to have mortgages from companies that were based elsewhere in the rest of the UK, rather than in Scotland, because if the Scottish currency were to depreciate, people might find it very difficult to repay their mortgages—even more difficult than it is at the moment for many people. A higher rate of interest could likewise affect pensions and all sorts of other things. It just tends to feed through the market.

12:30

Professor Kay: We have to be careful on this question. First, we have to ask what the currency would be in Scotland and, secondly, we have to ask the different question of what would be the currency in which people borrowed. Even if there were an independent Scottish currency, the Scottish Government could, and probably would, borrow in pounds rather than its Scottish currency, and that would also be true for private firms in Scotland and for people who take out mortgages here.

For people borrowing in sterling, I cannot see why it should make a difference to a Scottish company or a Scottish home buyer whether the lender is Scottish or not. For example, the Weir Group report on independence discusses why it would raise borrowing costs, but I cannot see why it would raise them any more than Novo's borrowing costs on global capital markets are raised by the fact that Novo is located in the small country of Denmark.

Equally, if Scots chose to borrow in sterling, I anticipate that they would be able to borrow on terms similar to those on which a similar person in England would be able to borrow in sterling. If Scots chose to borrow in a Scots currency—if there was one—the interest rate would clearly be determined by the interest rates in the Scots currency, which would in turn be determined by whatever the monetary policy of a Scottish central bank turned out to be.

Again, we have to be careful in talking about the actual legal position, the contractual position, the regulatory position and the nature of the contracts that people make.

Professor McCrone: The issue depends a lot on whether there is any exchange risk. I remember that when I was in the Scottish Office, a company more or less went bankrupt because it had borrowed in Deutschmarks and the pound had depreciated substantially over the period of the loan, so it simply could not repay the loan in Deutschmarks. If there is a currency risk, there is that danger.

If there is no currency risk because there is a currency union that everybody is happy with, and if there is no chance that it will be disrupted, there will not be much difference in interest rates. It is because there might be a different currency that I think, on the whole, that it would be sensible for people to have their mortgages from Scottish mortgage providers.

Professor McGregor: I agree with that. Monetary union makes things easier in that sense. Provided that people have confidence in the monetary union, it will eliminate the exchange rate risk part of the equation. However, for an independent Scottish Government within that monetary union, we would still expect a premium on the debt. That would certainly be reflected in Government debt, but depending on from where people had borrowed, it might not have a widespread impact throughout the Scottish economy.

Professor Kay: The one near certainty is that a Scottish Government would pay a bit more for borrowing in sterling than the UK Government pays for borrowing in sterling because Scotland would be a new borrower and Scottish debt would be illiquid relative to UK debt. Everything else would be pretty much up for grabs.

Gavin Brown: One or two members asked about economic growth. Putting corporation tax and the childcare idea to one side because you have given answers on those, are there in the white paper other ideas that would lead to significantly improved economic growth, relative to that in the UK?

Professor McCrone: I am not aware of any such ideas, but I may have missed them. The corporation tax and childcare proposals are the two concrete ones. I would very much like faster economic growth in Scotland; we have been trying for ages to bring that about. That is why I regretted so much the downgrading of regional policy in the 1980s. However, on where we should go from here, and how we might increase the rate of economic growth, we are all still waiting to hear. I have no solution to that problem.

Professor Kay: The largest issue is whether there would be a more vibrant entrepreneurial business community in an independent Scotland. That could go in one direction or another, depending on the nature of the society that was established after independence. However, that is the key issue that we ought to be talking about when considering economic growth and, indeed, economic issues generally.

Professor McCrone: The bit of the Scottish economy that has been disappointing over the years is the growth of the small business sector. We have done very well in attracting business from abroad, particularly during the 1980s. The Scottish Development Agency and, following it, Scottish Enterprise have done quite a lot to try to promote the small business sector. However, it remains the bit on which we need to do rather more. I have a number of suggestions in my book about that. I think that there is some advantage in trying to study what the Germans do with their mittelstand, which is a very important part of their economy. The banking sector in Germany operates in a much more supportive way for business there than the banking sector here does for Scottish business. To my mind, too much of the bank lending in this country goes into housing and not enough goes into other things.

Professor McGregor: Although I would echo many of those comments, I think that corporation tax and childcare seem to be the two main ideas for economic growth. However, that is not to say that the Scottish Government does not have control of other levers that might have an impact on growth. It is a very difficult area, but the Scottish Government has control over a large part of the spend, so there might be opportunities. I know that some people would claim that the opportunities are already being taken, but there might be other opportunities there for directing expenditure in a way that might stimulate economic growth, innovation and so on. If there is independence and greater fiscal autonomy, there might be the opportunity to revisit the kind of policies that Gavin McCrone has raised, and to undertake them on a self-funding basis. That might be worth exploring.

Professor McCrone: One of the areas that need to be looked at is vocational training. There has been a lot of emphasis on increasing the number of people who go through universities, but there has not been the same emphasis on trying to equip people with vocational skills to go into business, which is a weak spot. Again, the position in that regard is much better in Germany than it is here, and it is another aspect of the success of the German economy. The position here needs to be looked at.

I would also like to see the UK Government look more critically at the whole business of takeovers. There are occasions on which a takeover is necessary and, indeed, helpful—for example, when a company is in difficulty and will collapse if it is not taken over.

However, there are many cases in which a company is taken over just for aggrandisement of the management or because the shareholders will get a short-term gain, and so on. The Cadbury case is a well-known example in the UK, and the Scottish & Newcastle case in Scotland seems to me to be a similar example. I would like to see a bit more grit in the system, so that takeovers are not easily done unless it can be shown very clearly that the takeover will be to the advantage of the company and the country in which it operates. The present hullabaloo about Pfizer and AstraZeneca is an example of the same thing.

Professor Kay: Those are examples of how people have not got the significance of takeovers. The drain of corporate headquarters out of Scotland as a result of acquisitions over the past 20 or 30 years is one of the most serious issues in the whole debate.

John Mason: I am sure that the witnesses are glad that I am the last committee member who will ask questions. I want to go back to interest rates. A couple of people have said that if and when Scotland becomes independent we would, because we would not have a credit history, pay a bit more of a premium, at least to start with. I presume that that would not last. We have heard evidence that some smaller countries actually pay lower interest rates than some bigger countries. I presume that Scotland would have that potential—if not on day 1, then at least later on.

Professor McCrone: That would depend to a large extent on how we run the country. If there is any anxiety about the exchange rate, interest rates will be higher. I have not looked at the issue in detail, but it is usually the case that small countries pay rather more in interest than large countries do. John Kay perhaps knows more about this than I do.

Professor Kay: Small countries tend to pay higher interest rates in the same currency, as it were—the global currency—so nobody pays better dollar interest rates than the US Government, although the German Government pays a similar rate. Denmark pays low interest rates, but that is because there is a one-sided exchange rate risk, because the Danish krone might rise against the euro but is very unlikely to fall. Hong Kong is in a similar position vis-à-vis the dollar. If Scotland were to borrow in sterling, which we should presume it primarily would, we should and could expect it to pay a small premium to the rest of the UK Government for that, probably on a permanent basis, because—

John Mason: Would that be the case even if we were run more carefully than the UK?

Professor Kay: Yes it would, because the default risk in both cases is extremely small. It is really a familiarity and liquidity risk that is at issue.

Professor McGregor: One of the difficulties is that interest rates are the outcome of a number of complex influences, one of which is country size. The work that was referred to, which was conducted by my colleague Angus Armstrong and his colleagues at the National Institute of Economic and Social Research, attempts to control for all other factors. They do models in which they attempt to control for everything else, including the size of the country, debt to GDP ratios and other things that might influence perceived country risk. The estimates that they have come up with therefore take account, at least in principle, of the other factors. The 1 per cent premium that has been referred to on a number of occasions is the part of the interest rate level that they attribute to the small-country effect, so I clarify that that premium is the impact of the size of the country, trying to control as best we can for all the other determinants of interest rates.

Professor Kay: It is important, because it is a small-country effect, to say that we should not assume that it would go through to private borrowers.

John Mason: It would affect the Government more than it would affect individuals or companies.

Professor Kay: That is my view.

John Mason: Fair enough; that links in with my next point.

We have talked about the possibility that the financial sector might suffer and that some companies might move south if we were to become independent. However, it strikes me that Switzerland is a small country, but a lot of people have greater faith in Swiss banks—probably for historical reasons—than they have in banks in their own countries, so although it might be normal for an American to trust an American bank more than a Japanese or Chinese one, a lot of people throughout Europe would trust a Swiss bank. Is there also the potential for Scotland to do it the other way round and to have a reputation for really good financial skills?

Professor McCrone: Yes. Scotland would have to build up that reputation. When I ask the same question, people tell me that the Swiss financial sector is not the same kind of financial sector as the one in Scotland, because the one in Scotland is a kind of offshoot of London's financial sector. Similarly, there is a huge financial sector in Luxembourg and it does perfectly well. It would be perfectly possible for Scotland to have a very strong financial sector, but I suspect that it would probably have to change quite a bit from what it is now.

John Mason: Where would we rank now in the view of people around the world?

Professor Kay: We would rank very high, despite what we have done in terms of our banks. In asset management, we currently have precisely the type of reputation that John Mason described. The concerns about the financial sector are largely the kind of vague unease that I described previously. It is real, even if there is no basis for it, and I do not think that there is much basis for it.

The other concern is the fear, which I think is also rather ill-founded, that Scotland might have particularly inept regulation. I suggest that there is no particular reason to think that it would be more inept than any other regulation, although people are, at any rate, familiar with other regulation but not with ours.

12:45

John Mason: I am sure that ours will be better.

I move on to a different subject. The Barnett formula has been mentioned, although we have not spent a lot of time on it. It has been suggested that £4 billion could be taken off the Scottish block grant if Barnett was revised. Would that have a big impact on Scotland and the Scottish economy?

Professor McCrone: That would be the case if that happened. No party has said that it wants to revise the Barnett formula—they have all shied away from that—but there is a lot of pressure in England and Wales for it to be revised. The Holtham commission in Wales concluded that Scotland gets too much and Wales gets too little, which is perhaps unsurprising, since the commission was Welsh.

The problem is that, if Scotland is to defend a public expenditure level that differs from that in the rest of the UK while remaining in the UK, it must have some justification for that. At the moment, nobody knows what a needs assessment would throw up. The methodology for any needs assessment is quite difficult. The Scottish and UK Governments would have to agree on the methodology before the assessment was carried out.

The only needs assessment that has been done is the one that the Treasury did in the 1970s, which showed that Scotland deserved a higher public expenditure level than the rest of the UK, partly because many of its communities are scattered and partly because of deprivation in the west of Scotland. At that time, Scottish GDP per head was much lower in relation to the UK figure than it is now.

Joel Barnett keeps saying that the situation has completely changed, because Scottish GDP is more or less at the UK average, whereas it was not in the 1970s. I wrote to Lord Barnett to say that that was not the only consideration and that things such as deprivation and the scattered population were important.

When I was part of a national health service review group, I was struck that the costs of providing comparable health services in places such as the Western Isles, the northern isles and even the Borders are much higher than in Lothian, for instance. All of that needs to be taken into account in any proper needs assessment.

I guess that, if a needs assessment were done, it would still show that Scotland should have a higher public expenditure level than the UK average, for all the reasons that I have given. However, it probably would not justify a level that is as high as the current level. That was the conclusion of the Welsh study. It said that, if the formula for determining public expenditure was applied to various parts of England, Scotland would not be able to justify spending that is 10 per cent higher—that is approximately the figure at the moment—although it could justify something that is a bit higher.

We do not know the position. Governments have shied away from the subject. That is all very well, but it means that defending the present system is difficult.

John Mason: There are political sides to that, too.

Professor McCrone: Yes.

John Mason: Professor McGregor mentioned the social wage and—if I understood it correctly—the concept of taking more of a partnership approach, which would involve the unions, the Government and employers talking together about whether we want a bit more tax so that we get a better education system and so on. Do other countries do that better than us? Could we do that better than we do at the moment?

Professor McGregor: I must be honest—I am not an expert on wage bargaining systems in other countries. However, I understand from people who know how such things work that such an approach has traditionally been a much more accepted feature of wage bargaining in the Nordic countries, although that might be facing tension and might be subject to change.

Could the approach be better here? I am not advocating anything. We have just tried to say what factors might influence the outcome. If Governments could persuade unions and employers to think in the proposed terms, benefits could be gained.

All the proposals—even the pro-union proposals—imply the ability to shift tax and expenditure levels significantly towards either the levels of Scandinavian countries or those of Baltic countries. That is not a narrow economic choice; it is a choice about the society that we wish to live in. In that context, it is appropriate to think about a more collaborative view of wage bargaining. I do not know how feasible that is but, if it was implemented, it could have benefits, and experience elsewhere suggests that it could have benefits.

The Convener: That concludes questions from the other members of the committee. I have a couple of brief questions, the first of which is for Professor McCrone.

You touched on welfare. In your submission, you say:

> "I do not see why a large part of the responsibility for welfare should not be transferred to the Scottish Government and Parliament."

Some provisions have been transferred, of course. Responsibility for council tax benefit was transferred, but only 90 per cent of the revenue was transferred with it, which cost local government and the Scottish Government £40 million. We understand that the bedroom tax may be devolved as well. The mitigation costs there are £50 million. I take it that you believe that, if responsibilities are to be devolved, the money should follow the policy.

Professor McCrone: Yes, absolutely. I think that housing benefit should be devolved and that carers allowance, attendance allowance, even disability living allowance, which the personal independence payment has replaced, the winter fuel allowance and television licences for people over 75 could perfectly well be devolved. That is in a devolution context, not an independence context, of course. If there was independence, the whole lot would go.

If that approach was taken, around a third of what the Department for Work and Pensions currently spends would be devolved. If that is added to what the local authorities and the Scottish Government are currently responsible for, the figure would amount to around half of the social welfare cost in Scotland.

I do not see any reason for not doing that. It seems to me to be an important advantage. People constantly say that they would like more welfare to be decided in Scotland. There is no reason why the rates for the things that I mentioned should not be different from what they are in the rest of the country.

The Convener: Yes, as long as there is not an opportunity to cut our budget further by not funding them.

Professor McCrone: Exactly. The money must follow them.

The Convener: I will try to end on an optimistic note. We have heard about all the uncertainties and risks with independence, and we have heard the question about how we would grow the Scottish economy. I will throw my question open to you all. You are all professors of economics, so I imagine that you are all bristling with ideas about how to make Scotland a more dynamic, prosperous and thriving nation. Assuming that it is a yes in six months—of course, the opinion polls suggest that it might not be but let us assume that it is—what would you do so that, 10 years from now, Scotland would be the dynamic, prosperous and thriving nation that we all want to see? Do not all rush to answer that question.

Professor McCrone: I mentioned three things. The training system needs to be beefed up so that we have first-class vocational training and decent apprenticeships.

We need to look at takeovers, how they are decided, and what the rules would be for examining them. When Norman Tebbit was Secretary of State for Trade and Industry after the

Royal Bank of Scotland affair—it was bid for by the Hongkong and Shanghai Banking Corporation and Standard Chartered Bank; I was very much involved in that at the time—he changed the law because he was so against what was ultimately decided, which was to keep the Royal Bank of Scotland as a separate entity. He took the regional consideration out of the Monopolies and Mergers Commission's remit in looking at the effect of mergers. I would like to see that going back in somewhere or other in the new legislation.

I would also like us to look at how on earth we can promote entrepreneurship and small business more effectively than we have done in the past.

Professor McGregor: I would take a fairly traditional economist's view—I think that that is where Gavin McCrone was coming from, as well. It is not that demand is not very important, but in the long run we need to stimulate the supply side of the economy in order to stimulate growth. That implies capital, investment and the labour force, although not just the quantity of the labour force, which is important. We can influence that in Scotland, potentially through migration flows, but we can certainly influence the quality of the labour force. The Scottish Government routinely does so through higher education—I have to mention that as a possibility—and innovative activity. Innovation and the creation of knowledge are often emphasised in higher education. That is very important, but what is crucial is the graduates that we produce and the skills that they possess.

A large percentage of the graduates that are produced in Scotland remain in Scotland and contribute to the quality of the labour force. Education generally and training are therefore definitely important and augment the quality of the labour force. However, another factor that is much more difficult to pin down is entrepreneurial spirit, if I may call it that. There may be ways of stimulating that, but I am by no means an expert on that.

The Scottish Government has sought to identify growth sectors, a number of which would probably be agreed across the parties, and there may be policies there that could help matters. Until fairly recently, there was widespread agreement that renewable energy is a potential growth area. There are a number of sectoral areas that people could look at, as well as the overall picture.

The Convener: I understand that food and drink and the biosciences are other potential growth areas.

Professor Kay: A large proportion of graduates stay in Scotland but, equally, a large proportion do not. We should be emphasising business. I had not known, until the past few days, that the chairman of Pfizer is a Scot. There are many people in important positions in large international companies who originated in Scotland but who have not been working in Scotland over the past 20 years. If we could get even quite a small proportion of those people back in Scotland, that would make a difference in creating the vibrant business community that we are talking about.

For me, the largest part is understanding that the big cap in the provision of finance is on funding to cover the start-up losses of new small businesses. That is where funding is needed but, if anything, banks have withdrawn from it, as they have withdrawn from everything. Venture capitalists have also withdrawn because they have found it easier to make money by funding buy-outs of established businesses and through various kinds of financial engineering. It will be key to create institutions that provide a mixture of angel-type funding and private money. I suspect that Government funding would be better directed towards helping on the procurement side than towards providing the finance—it would be better if that were done privately.

Those are the kind of issues on which we should concentrate, and that is the emphasis that Gavin McCrone and Peter McGregor have been talking about. How we can create effective small businesses and entrepreneurship in Scotland seems to be the big issue in the debate about where we will be in 10 years' time.

Professor McCrone: I was involved in setting up the Scottish Development Agency in the 1970s. One of our aims was to get the SDA to help to provide finance for business start-ups and so on, and it did that to an extent. However, whenever a company failed the agency was hauled before the Public Accounts Committee of the House of Commons and given a hell of a grilling. We have to expect that some of them will fail—it is in the nature of the thing.

I agree with John Kay that it would be better for the private sector to provide the finance, but the public sector must be ready to lend a hand until the private sector gets adequately geared up, stops lending so much for people's mortgages and starts lending rather more for the promotion of small business.

Professor Kay: The private sector should provide the investment and the public sector should buy the product.

The Convener: It is obvious why so many Scottish graduates leave Scotland. I worked in the pharmaceutical industry, and because it is headquartered in the home counties people have to move there if they want career progression, whether it is in research and development or in management. A lot of the management are Scots—I worked for companies that were all

Scots—because they are seen to be sociable but assertive at the same time. Ireland is an independent country, so the whole infrastructure is there; companies have headquarters in Ireland, but nothing in Scotland.

Does anyone want to make any final points before we wind up this evidence session?

Professor McGregor: I have a brief point to make. The percentage of graduates who remain in Scotland is actually really high—it is of the order of 90 per cent. I do not deny that the export of human capital is an important issue. If we could retrieve some of that, that would be great. However, we retain a higher proportion of graduates than any other part of the UK, which is beneficial.

The Convener: Thank you for your evidence, which has been fascinating. I also thank my colleagues around the table for their wide array of questions.

Meeting closed at 13:00.

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