The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

FINANCE COMMITTEE

Wednesday 4 June 2014

Session 4

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FINANCE COMMITTEE
18th 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 Andrew Hughes Hallett (University of St Andrews)
Scott Mackay (Scottish Government)
Stuart Robb (Scottish Government)
Michael Russell (Cabinet Secretary for Education and Lifelong Learning)
Gemma Tetlow (Institute for Fiscal Studies)
Ben Thomson (Reform Scotland)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

Committee Room 1

Scottish Parliament

Finance Committee

Wednesday 4 June 2014

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

Decision on Taking Business in Private

The Convener (Kenneth Gibson): Good morning, and welcome to the 18th meeting in 2014 of the Finance Committee of the Scottish Parliament. I remind everybody present to turn off mobile phones, tablets and other electronic devices.

Our first item of business is to decide whether to take item 5 in private. Do members agree to do so?

Members *indicated agreement.*

The Convener: Before we move to item 2, I point out to colleagues that we have a lot of business to get through this morning. I ask members to keep their questions fairly brief; I will endeavour to do the same.

Children and Young People (Scotland) Act 2014

09:30

The Convener: Our second item of business is to take evidence on the Children and Young People (Scotland) Act 2014 from the Cabinet Secretary for Education and Lifelong Learning. He is accompanied today by Stuart Robb and Scott Mackay from the Scottish Government.

I intend to allow around an hour for this part of the meeting. I welcome Mr Russell to the meeting and invite him to make a short opening statement.

The Cabinet Secretary for Education and Lifelong Learning (Michael Russell): Thank you, convener. As you may have noticed, I am not Aileen Campbell. I proffer her apologies; she has, unfortunately, been taken ill. I look forward to answering the committee's questions today, to the best of my ability.

I thank you for the opportunity to give evidence on the additional capital costs that are associated with implementing the early learning and childcare commitments for additional two-year-olds, in relation to the supplementary financial memorandum for the Children and Young People (Scotland) Act 2014.

My colleagues and I appreciate the need to provide the Finance Committee with that information, and I know that Aileen Campbell would like to have got it to you sooner. Unfortunately, in the very short period between the new provisions being put forward and the date by which the supplementary financial memorandum was required, it was not possible to secure the essential information that was required for making a robust estimate, nor even to provide the committee with a best estimate.

We want to make sure we get the information right in order properly to inform parliamentary consideration and to deliver the policy properly. That has meant our going through a complex process that has required close engagement with local authorities, through the Convention of Scottish Local Authorities, to produce what I believe is now a robust estimate.

The Scottish Government is committed to funding fully the agreed costs of the policy. We have already committed more than a quarter of a billion pounds—£280 million, in fact—to local authorities to support implementation of our early learning and childcare commitments. That includes significant capital funding, £59 million over the next two years in revenue costs for the expansion for two-year-olds and £3.5 million of funding to strengthen the capacity and skills of staff. That demonstrates how seriously we take the policy and how committed we are to delivering it.

With regard to capital costs, we have already made significant funding available. In the original financial memorandum, we provided £90 million in capital over three years for additional capacity for three-year-olds and four-year-olds. The Cabinet Secretary for Finance, Employment and Sustainable Growth reaffirmed that commitment with a further allocation of £31 million to the capital funding requirement of local authorities for the financial years 2014-15 and 2015-16, specifically in relation to the expansion of early learning and childcare to additional two-year-olds.

The method for estimating the capital costs that are associated with the provisions is not straightforward and has required close engagement with COSLA and local authorities. We have analysed data from local authorities, which includes their estimates of required investment, and recent examples of capital that has been spent on the nursery estate for new builds or adaptations.

The work has been underpinned by data on location and numbers of eligible children, along with estimates of likely uptake rates, availability of existing capacity and distribution of children among local authorities and partner providers. That work has shown huge variations in the costs that are applied by local authorities and in the delivery models.

We have not yet been able to reach a final agreement with COSLA on the figures, although we intend to do so. However, we have produced a proposal, which is detailed in the paper that members have in front of them. It suggests an overall capital cost of £61 million for the extension of early learning and childcare to 27 per cent of two-year-olds. I believe that that represents a fair allocation that is drawn from clear evidence from the data that were submitted by local authorities on the costs of recent new-build and adapted accommodation, linked to the latest available statistical information on uptake rates and existing capacity.

The process has necessarily been complex, and although we have not yet been able to reach final agreement with COSLA, we will continue to engage with it and with local authorities, and we expect to reach agreement.

I am, of course happy to take questions.

The Convener: Thank you very much for your opening statement. As is normal on the Finance Committee, I will ask some opening questions before I open out the meeting to colleagues.

Paragraph 4 of annex A of your submission states that

"Twenty returns have been received and analysed by the Scottish Government."

It adds that there has been

"wide variation in costs per child being applied from £1,000 to £23,000."

How can you give such a definitive figure of £61 million when it seems that the figure is not based on all 32 local authorities?

Michael Russell: The answer to your question is in the detailed information that we have provided to the committee, in particular the metric that we applied. Paragraphs 14 to 16 and table 1 indicate the overall calculations and the following paragraph shows how the metric was developed based on the local authority examples. I ask Scott Mackay to expand on that, but I think that the figure is based on very firm information and experience from, for example, the well-advanced work of the Scottish Futures Trust.

Scott Mackay (Scottish Government): Not all local authorities sent us data on new build and estimates of future build. We analysed what was available in order to underpin an average, which was generated in the metric that is displayed in the submission.

The Convener: One of the issues about which COSLA has raised concerns in its submission is the 60:40 split in provision between the public and private sectors. It states:

"this is by far the most significant issue and this aspect needs to be reconsidered."

COSLA's submission states that

"Private providers have been approached but in the vast majority of Council areas they are unable or unwilling to offer places for 2 years olds."

The submission goes on to say that

"Two Councils in the west of Scotland are needing to work on a 100% local authority provision, with one of these Councils finding that only 1 of 70 private providers is willing to place 2 year olds from families seeking work. ... As an average, COSLA considers the true split of local authority provision will be between 80-100%."

It suggests that that means that the figure of £61 million is somewhat optimistic.

Michael Russell: We do not believe that it is, and I will tell you why, convener.

The latest pre-school statistics show that, on average across Scotland, 60 per cent of early learning and childcare provision is delivered by a local authority, and 40 per cent is delivered through partner providers. The pre-school statistics show that 5,700 two-year-olds receive funded early learning and childcare, of which 50 per cent is delivered in local authority settings and

50 per cent by partner providers. Where such provision already exists, 60:40 is a favourable split for local authorities. COSLA has given examples of a number of councils that are using up to 100 per cent local authority provision. I do not deny that, but we have seen a number of examples of councils using partner providers to deliver in excess of 60 per cent of provision and, in some cases, 100 per cent.

There is a variation in current practice and in plans around the use of partner providers. We propose that the acceptable split needs to draw on current experience and what is happening. That leads us to the 60:40 split. I am not saying that negotiations cannot continue and, of course, in a negotiation both partners take robust positions in discussing the matter. However, the evidence that we have is that the 60:40 split is an accurate split and is based on actual activity now. Of course, we will continue to discuss the issue.

The Convener: COSLA's submission states:

"The information obtained from Councils has been shared with Scottish Government officials during our discussions, and we had agreed a process to seek further clarification from Councils to help in the discussions with the metric. However, before this process could be completed we received an updated copy of the metric",

which basically said that the figure had been set at £61 million. If negotiations are continuing with COSLA, how flexible are you about the figure?

Michael Russell: There was an obligation on Aileen Campbell to come to the committee and give it further information. It is quite right that she did so. The metric that we have been working on is the information that you required. The metric leads us to the figure of £61 million. The COSLA figure is very substantially higher, but we have moved from earlier discussions of a lower figure. We will continue to discuss the issue, but we are confident in our robust calculations. Of course, there will be flexibility, but in terms of our estimate of what is taking place, the calculations that are laid out before you are very robust.

The Convener: I have one more question before I open the discussion out to colleagues. We are talking about a policy that will have to start being delivered from August, although discussions are still on-going with local authorities and COSLA. How confident are you that we will be able to commence the policy from August, as intended?

Michael Russell: I am entirely confident that we can do that, but we are also offering local authorities as much help as we can, which is the right thing to do. I do not question COSLA's commitment; from the beginning, COSLA has shown a strong commitment to the policy. In turn, we have said that we will fully fund it—there has been no question about that. We are now talking about the detail.

Let us remember the numbers that are involved. Roll-out will start in August with a comparatively small number, which will rise over the next year and a bit from the 15 per cent that is to be achieved at the end of the first year to the 27 per cent that is to be achieved at the end of the second year. In those circumstances, what requires to be spent now can be spent now. Further discussions will have to take place, but I am confident that authorities can deliver.

Members will understand that delivery will be most difficult in rural areas because of the need to provide for small or very small numbers. I represent a rural area, so I understand that. We will give COSLA every assistance. We are trying to deliver the policy as partners and we are confident that we will do so.

Jamie Hepburn (Cumbernauld and Kilsyth) (SNP): You could have chosen a legislative instrument other than the Children and Young People (Scotland) Bill to implement the policy, which could have been in a stand-alone bill. What might have been the effect of that?

Michael Russell: A stand-alone bill would have delayed implementation. The timeline on which we decided shows that we are trying to achieve as much as possible as early as possible. It is important to consider that timeline and how we got here.

We introduced the bill on 17 April 2013. On 5 December 2013, the Chancellor of the Exchequer made the autumn budget statement, which included consequential funding. On 7 January, the First Minister said that we would use consequential funding to expand provision to 15 per cent of two-year-olds in 2014-15, which will rise to 27 per cent in 2015-16: we said only in January this year that we would try to do that. There was a lot of parliamentary interest in that and we believed that we should try to do it.

On 19 February, stage 3 took place and the committee had its final discussion of the financial memorandum. On 19 March, the chancellor's United Kingdom budget included consequentials. On 1 April, John Swinney announced the use of the entire £31 million of capital consequentials as a down payment on the capital costs. It was accepted that that would not be the final position. What he said was important. I quote:

"We will continue to work with our partners at the Convention of Scottish Local Authorities to fully understand the capital cost implications of the expansion of childcare services, but the initial investment of £23.5 million in 2014-15 and £7.7 million in 2015-16 will emphasise our determination to properly resource our early learning and childcare services within the constraints of devolution."—[*Official Report*, 1 April 2014; c 29606.]

We have moved quickly to deliver something that is required and desirable, but the negotiations will take longer. If we had not done what we did, we would not have been able to deliver the policy this year and we would have had to use a special legislative vehicle or part of another bill. The earliest we could have done that would probably have been next year. If we had had to wait for a bill to be passed next year, that might well have meant a delay not of a single year but of two years. We did not want that.

Jamie Hepburn: So, 15 per cent of two-year-olds would not have been getting the provision by the end of 2014-15—that could have been delayed until 2016-17 or later.

Michael Russell: Yes. You put it more succinctly than I did.

Jamie Hepburn: You estimate that the average capital cost per child will be £6,900, which is lower than the schools for the future metric. Will you explain the difference? Is it down to the fact that the approach differs slightly from the schools for the future programme, which involves new builds?

Michael Russell: Scott Mackay will talk about the metric, which is complex. It covers new build, reconstruction and other actions, and it also involves sessions. We calculate the cost per pupil, but the new metric involves the cost per two pupils, because there are two sessions a day.

Scott Mackay: The detail of the metric and the variation from the standard Scottish Futures Trust metric result from the interaction with COSLA and the acknowledgement that different types of build have different costs.

Based on the returns that we received, we factored in an adjustment for the costs of adaptations to existing provision, we included a standard cost—an approximation of the costs of a new build was accepted—and we adjusted for a slightly higher cost of extensions to existing build. After factoring in all those costs, we came to the revised figure in the table. That was an attempt to reflect the information that we had received from COSLA on cost variations based on the type of provision that is needed in particular areas.

09:45

Jamie Hepburn: Thank you for that. COSLA's paper makes the point on discussions that the cabinet secretary made. It says:

> "COSLA has had a number of discussions with Scottish Government officials around the capital costs and the use of a metric was first proposed by Scottish Government in early May. Through discussions some of our concerns have been taken on board."

That is COSLA's view, but will you respond and set out how the Scottish Government has moved towards taking on board COSLA's concerns?

Michael Russell: It is probably for the officials who were involved in those discussions to respond to your question.

Stuart Robb (Scottish Government): The main shift in our position to meet COSLA's concerns has been on full-time equivalent places. We have moved to two children per space on the basis that local authorities deliver sessions in the morning and the afternoon. Our previous estimates had a slightly higher figure.

Scott Mackay mentioned the cost per child metric. We have looked at the data from local authorities and we have adjusted our capital expenditure costings in the original financial memorandum based on that information. We have increased the cost for extensions, as Scott said. We have also adjusted the split between the adaptations, new build and extensions that local authorities are expecting to deliver, and we have factored all that into the calculations, which has resulted in a higher figure.

Jamie Hepburn: In the process of dialogue and negotiation, has the Government taken on board what COSLA has said?

Stuart Robb: Yes.

Michael Russell: We will continue to do so. We are having a positive debate. We think that we have a robust metric, but we are listening.

Jamie Hepburn: Thank you.

Gavin Brown (Lothian) (Con): Cabinet Secretary, you explained that it was not possible to give capital costs in the supplementary financial memorandum because of the lack of time between 7 January, when the new provisions were presented, and the supplementary financial memorandum's publication at the end of January. Why has it taken almost five months to get any details on capital costs to the Finance Committee?

Michael Russell: As I tried to indicate with the timeline, the process has been fast moving. The original bill had only a tiny inclusion on two-year-olds, but in January it was decided that they would be a major feature. Capital money was allocated only in March, which was followed by discussion of the metric process.

On 1 April, John Swinney announced the allocation of the money. The reality is that we should look at the process only from 1 April until now which, by my calculation, means that we have been looking at the matter for only two months and a few days. Since that time, following the down payment of the full amount of the consequentials and how we took that on, a complex series of discussions have taken place about how to progress the work.

We have reached a position whereby the discussion is meaningful, but we have not finished the debate, I suppose that, in a sense, Aileen Campbell, on whose behalf I speak, would have preferred to have come here with a final agreement with COSLA. We are not in that position, but we are in a position to share substantial information and to show, if I may put it this way, the workings.

Gavin Brown: The policy was announced in January, the supplementary financial memorandum was published at the end of January and the legislation was passed in February. Why are you saying that we should count only from 1 April?

Michael Russell: We have a situation whereby, on 1 April, the first scoping out of the money that would be made available was announced by the cabinet secretary. I quoted his words when I said that we had

"an initial investment of £23.5 million in 2014-15 and £7.7 million in 2015-16."—[*Official Report*, 1 April 2014; c 29606.]

From then on, it has been a matter of negotiation.

We are where we are—we are having a detailed discussion, and that is useful. The alternative would be to say that we could not implement the policy this year, that we should put the issue away, that we should not address it in legislation and that we should not put the money aside for it. In that case, as Mr Hepburn has pointed out, there would be a delay in implementation. That would not benefit the children whom we are trying to benefit.

Gavin Brown: The alternative would be to have done the scoping before announcing the policy.

Michael Russell: The policy was something that we wished to pursue. When the money became available, we tried to find a way to do that. It is a positive and ambitious thing that we have been trying to do, and we are getting there.

Gavin Brown: I understand that a Scottish statutory instrument, the Provision of Early Learning and Childcare (Specified Children) (Scotland) Order 2014, was laid on 19 May this year, with a figure of £31 million attached to it. How was that £31 million figure reached?

Michael Russell: I have just explained to you that it was the entire capital consequentials that were available from the budget. John Swinney said:

"We will continue to work with our partners at the Convention of Scottish Local Authorities to fully understand the capital cost implications of the expansion of childcare services, but the initial investment of £23.5 million in 2014-15 and £7.7 million in 2015-16 will emphasise our determination to properly resource our early learning and childcare services within the constraints of devolution."—[*Official Report*, 1 April 2014; c 29606.]

That is what was available, and that is what we were starting with. I think that it was the right thing to have a discussion and debate with COSLA to see what the final figure would be.

Gavin Brown: To be clear, that was based on what was available in consequentials, as opposed to what you thought would be needed.

Michael Russell: As John Swinney put it, it was an "initial investment". We were listening, and we should be listening. We continue to listen, debate and discuss.

Gavin Brown: COSLA is saying that its estimate, from what it calls a "bottom-up" exercise, is £114 million. You are now saying that the amount is going to be £61 million. You said earlier that both parties take a robust position and then discuss and negotiate. Is your £61 million basically you taking a robust position for discussion and negotiation?

Michael Russell: No. As I am sure you are aware—I am sure that you have read the paper—

Gavin Brown: Of course.

Michael Russell: The £61 million is based on the metrics. That is a provable figure, and it is the figure that we are discussing. Sparing my officials' blushes, I think that the set of calculations were well worked out as regards what we believe to be the right approach.

I am not going to indicate an inflexibility, as there is no inflexibility. We are working as partners on the matter, and we will continue to do so.

Gavin Brown: We heard evidence from the Scottish Government on 19 February. In response to our questioning about the capital costs, the Government said:

"we have shared our working and calculations with COSLA ... and concerns have not been raised".—[*Official Report, Finance Committee*, 19 February 2014; c 3665.]

At that point, workings had been shared and concerns had not been raised. How do you explain that statement, given what COSLA has said in its written submission to us, where it is clearly raising what it describes as "significant concerns"?

Michael Russell: Considerable work has been done since then on both sides. No indication was given that there was an agreement, and we have continued to proceed in a very positive way. However, there was no final agreement—there was not even an interim agreement. A lot of work has been done since that time, and that will continue.

Gavin Brown: But it remains the Scottish Government's position that there were no concerns from COSLA in February this year.

Michael Russell: It depends on the interpretation of "no concerns". There was a good mutual relationship, and that continues. There is clearly a discussion to be had about the fine detail of paying for something.

Gavin Brown: With respect, it is not—

Michael Russell: Does Scott Mackay wish to say anything about that?

Scott Mackay: I was not at the evidence session on 19 February, but I think that that statement was made in the expectation that we would continue to engage positively with COSLA until we achieved a resolution.

Gavin Brown: You are saying that it is a matter of interpretation. Either COSLA had raised concerns at that stage, or it had not. Which was it?

Michael Russell: The evidence that an official gives is the evidence that the official gives. They obviously have a good, positive relationship, and they have been discussing the matter. We continue to discuss it. Figures have been worked on and have varied since that time. We are trying to deliver the policy in partnership in a way that benefits two-year-olds. It is a positive approach from both sides.

Gavin Brown: Okay. In relation to timescales, obviously the pace needs to accelerate somewhat if the policy, or at least a portion of it, is going to be delivered in 10 weeks' time. How many children will be eligible as of August 2014 for the first cohort?

Michael Russell: The figure is 3,440—well, that is the anticipated take-up figure.

Gavin Brown: How many will be eligible?

Michael Russell: That figure is 70 per cent of the total eligibility figure. Is that correct, Stuart?

Stuart Robb: Yes.

Michael Russell: So we will get the figure for 100 per cent by adding to the 70 per cent figure of 3,440.

The total eligibility figure is roughly 8,000 for the 15 per cent target. The anticipated take-up is 70 per cent, which would give an anticipated take-up for the 15 per cent target in the first year of 6,800. The anticipated figures have been broken down for the phasing timetable, of which you are aware. The exact anticipated figures—which I fortunately now have in front of me—are 3,440 in August 2014, 2,293 in January 2015 and 1,147 in March 2015. Therefore, the estimate for August is 3,440.

Gavin Brown: Thank you. That is cohort 1, and time is tight, as we are only weeks away from the August start. Assuming that the 3,440 figure is correct, how do you know definitely that they can all be accommodated?

Michael Russell: I know that local authorities wish to ensure that that happens and that that is their intention. I am therefore sure that they will be able to make that provision. I would like to have that resolved as soon as possible, but we would expect local authorities to make that provision and we are continuing to work with each local authority to help them to do so. We will go on doing that right up until the first day of term—although there will not of course be a universal first day of term, as it varies from place to place.

Gavin Brown: I get that, but do you see what I am driving at here?

Michael Russell: I do.

Gavin Brown: The local authorities are raising concerns about whether that can be delivered. I am asking you how you know that it can be delivered.

Michael Russell: I believe that the local authorities want to deliver it as much as the Scottish Government does, because we are doing it for the benefit of two-year-olds. We believe that the policy is right. It has been challenging from the beginning, but we are going to continue to work together with the local authorities to deliver it. That is our firm intention, that is what we want to do, and that is what we are working together to do.

Gavin Brown: How many of the 3,440 will require some form of building work or adaptation to happen?

Michael Russell: I do not think that it is possible to say whether that is the situation. We must remember that COSLA applies a formula, so I do not think that it is possible to say how many of those will require additional build places.

I think that we can apply some logic to this. Given that we are talking about 3,440 and that the ultimate total—once the 27,000 is in—will be 12,971 minus the ones already in the system, we are really talking about something like a quarter of the total. I would have thought that it would be much easier to accommodate those in existing space, if that were required, than it would be, for example, to accommodate the total after the two-year process. I think that there will be the good will to do so.

Gavin Brown: I guess that that is my question: can they be accommodated in existing space?

Michael Russell: The local authorities wish to do so, we wish to do so, and our intention is to do so. Mr Brown, I am doing my very best to indicate to you that there is a strong commitment to the policy on both sides and that we intend to deliver it.

Gavin Brown: Thank you.

Michael McMahon (Uddingston and Bellshill) (Lab): Again, the issue comes down to some of the figures that have been used. You have been very specific in terms of the number that currently exists, which is 12,971 minus the 1,983. I suppose that it is easy to be specific when you already know that those children exist and you can count them.

You then have to project, but the figures become a bit less clear. I understand that. However, according to the financial memorandum, the figure that you used would suggest that an additional 10,988 places are going to be required, whereas the supplementary financial memorandum suggested that the additional figure for two-year-olds from August 2014 would be 8,400 and would rise to 15,400 from August 2015. There is therefore a question because, no matter how you do those sums, they do not come out to the same figure. Can you explain that to us?

Michael Russell: I was myself concerned when I saw those figures. Let me explain them to you, because I had to ask for an explanation. If I fail to explain them adequately to you, I shall ask the person who explained them to me—Mr Robb—who will then explain them to you.

10:00

The figure for total eligibility at the end of the second year—which is the 27 per cent—equates to the 15,400. That is the total eligibility at the end of year 2. The assumed take-up rate in year 2 is 84 per cent, which is higher than the assumed 70 per cent in year 1. That is because experience elsewhere tends to show that the take-up rate for the first group will be lower than the subsequent take-up rate. There is also a particular issue in the group that is eligible in relation to the first take-up rate. Parents from workless households paradoxically may already have made some arrangements, because they themselves often do the care.

Therefore, the assumption for year 1 is a take-up rate of 70 per cent and the assumption for year 2 is a take-up rate of 84 per cent. The eligibility figure goes from 15 per cent in year 1 to 27 per cent in year 2. The figure for the end of year 2 is 15,400. If I am correct, an 84 per cent take-up rate is 12,971. When we take away from that the children who are already in the system, we come to 10,988.

In year 1, the eligibility figure is lower, as we are dealing with 15 per cent. The 8,400 figure relates to the total entitlement in year 1, which is a lower figure. The assumed take-up rate of that total entitlement is 70 per cent. That gets us down to the expectation that the figure will be around 6,800 in the first year, which is further subdivided by the phasing of the take-up. The first phase will involve 3,440. That is the phase that comes in this August, and it builds up to 15,400 at the end of year 2.

That is how it plays out. I had to have that explained to me this morning. I hope that I have explained it adequately.

Michael McMahon: You certainly have. The difficulty is that that answer must have been known when the SFM was drawn up, so why could you not give us that answer and explanation at that time? If you did, we would not have had to speculate on why those figures do not add up and it might have helped the misunderstandings about affordability and deliverability between COSLA and the Government.

Michael Russell: Perhaps Stuart Robb can explain that.

Stuart Robb: We did not know those figures at that time. The initial announcement was based on annual statistics that related to the number of children in workless households. Since then, we have had to work with COSLA and the Department for Work and Pensions. Members will have seen the criteria that we set out in the eligibility order that has been laid. We had to identify the qualifying benefits that would allow us to identify the right number of children, and it took a bit of time to get to that stage. We therefore did not know the exact numbers at the time.

Michael McMahon: I understand that you might not have known the exact numbers, but there was a disparity between the financial memorandum and the supplementary financial memorandum. Those figures were in the SFM, so you knew them. The explanation about why there was a difference was missing.

Michael Russell: That is a fair point, and I am glad to have been able to provide an explanation today. You are absolutely right to say that it would have been better to have provided that earlier.

Malcolm Chisholm (Edinburgh Northern and Leith) (Lab): I want to look at the two basic reasons why COSLA is in disagreement with you. The convener has already touched on one of them, but I want to ask further about it.

Your response to COSLA's objection to the 60:40 split was to quote current percentages. Are you confident that the composition of the two-year-old cohort that currently has childcare will be identical or even similar to that of the new cohort? I suppose that many two-year-olds who are currently in private provision get all-day provision, as their parents work, for example.

I will quote just one sentence from COSLA's submission—I do not know whether it is right, but it possibly makes some sense. COSLA said:

"private providers can be reluctant to provide the service for 2 year olds from workless households due to the expectation that the parents would be unlikely to buy additional further hours from the provider."

I suppose that it is true that the majority of the new cohort of two-year-olds will not necessarily be from workless households, but they will certainly be from households that will not pay for extra hours for one reason or another. I wonder whether the percentages that you quoted are directly relevant to the new situation.

Michael Russell: That is a fair point, but we have not seen that evidence from COSLA. Equally, we believe that there is no evidence that a local authority will have to provide all of that provision itself or that it would do so where there is not already some existing capacity. We have not been inflexible in that discussion, but we have seen no evidence that suggests that. The evidence that I have quoted shows that provision for two-year-olds is provided by private providers, and there is no evidence that they will stop providing that.

We are not inflexible in the discussion and, because the policy is fully funded, the actual revenue cost of meeting that policy aim—were it to fall more extensively upon local authorities—would be reflected. I do not think that we are seeing the evidence from COSLA that proves the point, and the evidence that I have quoted shows that private providers will continue to play a major role. There is a capacity question as to whether local authorities would be able to provide in that way without fairly major changes, so I think that the Government's assumptions are reasonable.

Malcolm Chisholm: The second point that COSLA makes—it makes only two major points—appears to be more objectively provable, because it questions your estimate of the cost per square metre of new build. COSLA says that it should not be an estimate, because

"the cost per metre for a new build provided for in the metric is £2,400, however figures obtained by COSLA suggest that £2,800 per square metre is more realistic".

One would think that that could be proved one way or the other.

Michael Russell: Mr Chisholm, I share your hope in physical fact, but I have found, having dealt with the Scottish Futures Trust funding for school buildings, that there is often a huge debate that rages over a long period of time about what the actual costs will be. I shall ask Scott Mackay to address that, because it is a debate that arises especially in the provision of school buildings.

Scott Mackay: We have drawn the figures on the basis of the data that was provided to us by individual local authorities, as the COSLA paper says. Because of the timing of our commitment to appear before the committee, we had to submit the paper to you before we really had a chance to engage fully on the detail of that metric. I expect to be able to resolve that with further discussion. We are perfectly willing to share the details of information that we have based our figures on and how we have arrived at them, and I hope that that discussion will allow us to arrive at some consensus.

Stuart Robb: I can add a bit of detail about how we have reached the £2,400 figure and how that has fed through into the calculations.

The figure of £2,400 is based on the metric used for the schools of the future programme, which we agreed with COSLA for the previous allocation of capital. For that reason, we used it as a starting point. However, it is clear from the information submitted by local authorities that the costs per square metre vary depending on the type of capital programmes that are being considered. For example, adaptations are cheaper than new build and extensions are more expensive than new build.

Accordingly, as set out in table 2 of the proposal, we adjusted the cost per square metre to reflect the different kinds of capital costs that local authorities have told us will be involved. From a new build figure of £2,400, we are down to £1,700 for adaptations, because they are cheaper, and up to £3,100 for extensions. Based on local authority returns, we have estimated a split of 30 per cent adaptations, 30 per cent new build and 40 per cent extensions.

John Mason (Glasgow Shettleston) (SNP): Since we are talking about square metres, are we clear about whether all the councils are on a level playing field when it comes to how much space is needed for each child? There is mention of areas from 2.8m^2 up to 7.5m^2 but, if I understand the figures correctly, that is because we are sometimes talking just about the play area that the kids are in most of the time, not including office space, changing space, cloakrooms and all those things. Is it all the same when you boil it down?

Michael Russell: It is, from a wider educational perspective. Those are exactly the issues that are addressed in the new build and replacement of primary schools and in questions of school closures when considering what the space occupied by a child would be.

Stuart Robb is better placed to talk about the issue in this context, but it is a common problem in the negotiation that takes place about any educational establishment or building and in determining how to reach an agreement on the total space occupied and how that space is used.

Stuart Robb: In the returns that we had from local authorities, some used the Care Inspectorate metric, which involves a figure of 2.3m^2 to 2.8m^2; some used a different measurement, which comes out at about 5m^2; and others used the schools for the future programme figure, which is 7.5m^2. Other authorities have used slightly different figures. On average, we have come out with the figure of 7.5m^2 as the right one. There is huge variation in the returns from local authorities.

John Mason: Is it the case that some councils are more optimistic, or do some just want more space than others?

Stuart Robb: You were right when you said that the lower cost metric includes just the play space. That is perhaps what some authorities have used for their costings, whereas others have done that by including all the other facilities. That is what is included in our metric—it covers a wider area.

Scott Mackay: The figure of 7.5m^2 is in essence the highest figure. In the calculation, we make a full estimation of all the additional space that is required to support the provision.

Michael Russell: It is significant that we have not accepted the lower figure. That was done after some thought and because we have seen circumstances in other school building processes in which lower figures were accepted. That is not really what we are trying to aspire to.

John Mason: That is helpful. As long as that is all being looked into, I am content. I know that, with primary school buildings, councils have had different ideas as to what is required.

On the point about private providers, I assume that the word "private" includes both the voluntary sector and what we would normally think of as private providers. Are we convinced that the councils are supporting, helping and approving the private providers? Historically, I have found that some councils have been a bit resistant to using private providers and want to do everything themselves. Are we convinced that it is really the private providers that are not willing, or is it the councils that are not willing to use those providers or to pay them properly?

Michael Russell: We have to be careful about our involvement in that issue. The delivery of the policy is an issue for local authorities—they choose how they will deliver it. Some local authorities believe that it is best to deliver that substantially through their own efforts; others believe that it is better and more cost effective to deliver it through the use of private providers; and there is a mix between the two.

I do not think that it is or should be our position to tell local authorities how to do that. The decision is rightly made by the local authority. There are national standards that have to be met, and we expect them to be met—indeed, they are enforceable. However, I would not intrude on that any further.

A local authority will have its own reasons for making a decision. Nobody would want us to second-guess a local authority's decisions in that regard. We need to know the balance of provision across Scotland, and we think that our estimate of that, from what we know of the sector, is correct.

John Mason: So if a family in one part of a council area had no provision near them and the council said that they should just travel to the other side of the council area to get the council provision, that would really be an issue between the family and the council and is not something that the Government would get involved in.

Michael Russell: Yes.

John Mason: My final point is to seek clarification on the figure of £61 million that we have touched on. In negotiations, one party starts at one end and another party starts at the other, and there is a movement towards the middle. Has the £61 million figure been reached after some movement towards the middle, or is it the starting point?

Michael Russell: It is not the starting point, but we are in the process of negotiation. We are talking about £61 million not only because it is our obligation in talking to the Finance Committee but because we believe that it is robust and well founded. We have laid out our workings, and that is the strong position that we find ourselves in, but we are discussing the figure. COSLA has talked about £114 million, but we do not agree with that figure, for reasons that we have given to COSLA. That is the position that we are in.

John Mason: Are you implying that you have already moved from a lower figure?

Michael Russell: Yes. I think that we were at £41 million some time ago. I am absolutely not ruling out there being a different figure at the end of the day, but I am saying that we believe that the figure of £61 million is well founded and well established and we stand by the metric that we are presenting to you.

The Convener: That concludes questions from members but, before you charge off, cabinet secretary, I still have some questions to ask, as is usual—I always have one or two wind-up questions.

I want to go back to the private sector issue. COSLA said in its submission:

> "the location of the private providers is usually not in the same location as the eligible children from workless households targeted by the policy."

How will the policy be delivered in areas in which a disproportionate number of children have to go to private providers, given the issues that we have talked about, such as the apparent resistance from the private sector and capacity in the public sector?

10:15

Michael Russell: That is a delivery issue for the local authorities, which, in Scotland, are charged with the responsibility of delivering education at those levels. If a local authority believes that there is not adequate provision in an area and is under an obligation to deliver, it will have to find the way so to do.

I do not entirely accept that there is no provision in some areas. That is a very broad-brush approach to take. The third sector is involved in delivery in a variety of places in Scotland and might well deliver in areas where there is a high percentage of workless households.

We want to support local authorities to be able to deliver the policy in all the places where it is needed—the places where there is any demand at all, not just the places where demand is highest. That is the purpose of our negotiations. We will provide the revenue support that is required, in its entirety, and we will provide the capital support for delivery, in its entirety. Ultimately, local authorities will make the delivery decisions themselves. That is what they are charged to do.

The Convener: As a result of the negotiations, you have increased the amount of capital from the £31 million that was announced on 1 April to £61 million. In relation to the private sector, if the issues to do with delivery that we touched on arise, will additional funding potentially be available to individual local authorities?

Michael Russell: No, I would not expect that to be the case. The allocation that we are making is for local authorities to deliver the policy; it would not be normal for local authorities then to fund private providers to expand their services. That is a decision that local authorities could make, but it would not be dealt with through the provision that we are talking about.

The Convener: Sorry, I was not clear. I was thinking about what would happen in an area if the private sector was unable to provide services and the burden fell disproportionately on the local authority, in the context of what had been estimated. Would there be additional funding for the local authority?

Michael Russell: There would be no disproportionate burden, because the local authorities should be aware of what it will take to implement the policy in their areas. Education is delivered through local authorities because they know their areas and understand the best way to deliver education at every level. That is the system that we have in Scotland from early years and right through the education system.

We would not second-guess local authorities and say, "You must deliver it in this way." The only area in which there is that sort of relationship is school closures, which is a complex area that is governed by legislation. In the circumstances that we are talking about, the current arrangement is that local authorities are keen on and will deliver the policy, and they are being fully funded to deliver the policy, but how they do so within that framework will be for them. I am sorry to keep stressing that, but it is absolutely the situation.

We do not interfere in the way that has been suggested. I think that members of the Parliament—indeed, members of this committee—might criticise us if we interfered in the decisions that local authorities rightly take on how they deliver policy.

The Convener: Okay. You emphasised that the Scottish Government will fully fund the policy. There is, of course, a disparity between what the Scottish Government says it will cost and what COSLA says it will cost, which we have discussed. Negotiations are still going on in that regard. If, after a year, it is clear that there is a funding gap, will the Scottish Government reassess the figures and ensure that the gap is effectively plugged?

Michael Russell: Yes, and I have made that clear to COSLA. We want to get this right, and we think that the best time to get it right is before we start, or in the process of setting things up, which is why discussions are taking place.

If COSLA comes back in a year or 18 months' time and says that it has discovered 10 things that it did not know about delivering for two-year-olds, we will of course have a serious conversation, because this is about ensuring that two-year-olds, progressively, get the early years education that we hope ultimately—through the powers of independence, if I may make that point—to deliver for all two-year-olds in Scotland. This is a growing service, and we would not want it to be adversely affected.

We have made a commitment to full funding and we will meet that commitment, but that does not mean that full funding is simply decided on by someone saying, "This is the figure; take it or leave it." There has to be negotiation based on robust fact, which is what we are trying to get to.

The Convener: Okay. Thank you. Is there anything else that you want to bring to the committee's attention?

Michael Russell: I will just say thank you for the opportunity to give evidence. I hope that we have clarified the issues that required to be clarified.

The Convener: I thank the cabinet secretary and his officials.

10:19

Meeting suspended.

10:25

On resuming—

Scottish Fiscal Commission (Nominee)

The Convener: We are all present and correct, so I reconvene the meeting. Our next item of business is evidence from the third of the Scottish Government's nominees for appointment to the Scottish fiscal commission—Professor Andrew Hughes Hallett. I intend to allow up to 30 minutes for the item. Members have received copies of Professor Hughes Hallett's CV and his completed questionnaire. I welcome him to the meeting and invite him to make a short introductory statement.

Professor Andrew Hughes Hallett (University of St Andrews): First, I apologise for not being here last week. Some of you might know that that was because of a long-standing commitment to what I might call my personal sustainability, which meant that I had to be elsewhere. That is all okay.

I will set the context a little, but if members know all about this, I apologise if I repeat things. Among many other things, I have worked on the use of fiscal policy councils—Scotland will have a commission—for quite a long time. It is of interest to me to look back. I started doing that work for a European proposition 12 years ago—I looked at how such a council would be used at the European Union level.

At that time, in 2002, we debated at great length whether the body would be at the EU level or the member state level. We went for the EU level—many of the functions have migrated into the European Commission—because we thought that the stability pact would manage to restrain member states and that the problem was likely to be at the EU level, where fiscal policies would get out of line, which would undermine or conflict with the monetary policy for the European Central Bank. We thought that, at the euro level, the Commission would use the stability pact to bring member states back into line, but we were wrong—the stability pact was not enforced. It was not designed in the way that I would have designed it, so perhaps it was a bit wrong in that sense, but the key point is that it was not enforced.

At the time, it was made clear to me that there was no way that member state Governments would be persuaded to have fiscal policy councils. However, things move on, and the financial crisis has changed member states' minds. A fiscal policy council is now needed at the member state level and, in this context, at the regional Government level—I say that without making any forecasts—to watch the fiscal policies that are under

Governments' control and to monitor the sustainability and quality of the forecasts for the fiscal policies.

In that sense having a fiscal policy council cannot be avoided, and in another sense it cannot be avoided, because the International Monetary Fund and the European Union require it at the member state level. Most countries now have such a council in some form or other, although the forms vary widely. Such councils are not required of regional Governments, but they are preferred, and a number of places have established them. Whether to have a council is not a referendum issue, because it is necessary with any degree of devolution. If there is no devolution, that is another matter.

On the other hand, the idea is a bit experimental. Fiscal policy councils elsewhere vary quite a bit in how they operate. We will need to feel our way through that.

A key feature of such a council is that it is forward looking about fiscal policies—that is the forecasting part. Another is that the council and its members should be independent, so they get to set the remit to a degree—that will be a simple matter for the Scottish fiscal commission to start with, as it will have only two taxes to worry about, but the issue might be more complicated later.

Fiscal policy councils get to set their mode of working, and they make their choice of forecasting models to use. They can determine the assumptions and data that they put in and their use of outside expertise, if need be. I can foresee some instances later—but not now—where that might be the case.

10:30

I suggest that the fiscal commission is subject to outside review to ascertain whether it is performing well. That need not be continuous; it could be every five or seven years, say. It is responsible and accountable to Parliament, rather than to any specific Government.

The commission has a functional independence, which matters as much as political and personal independence—perhaps I should go further and say that it matters more. It is a bit different from considering the independence of, say, the Bank of England monetary policy committee for monetary policy purposes.

That said, the key thing is that the fiscal commission does not have any decision role or executive authority. It cannot tell people what to do. Furthermore, it does not advise in a proactive sense, telling people, "You should do this." In bad circumstances, it is possible to make comments like that, but the commission cannot formally advise. It cannot engage in policy advocacy, in any sense. Importantly, it must restrict itself within the targets and priorities set by the elected Government of the time. It is not going to usurp democracy.

That is basically the background as I see it. My statements in response to the questionnaire—including all the typos that I found this morning—give some indication of my experience, albeit not on fiscal policy councils or commissions, as I have never been on one. My experience has been in a general policy advising sense, commenting on policy, rather than telling people what to do. One or two cases have been slightly more direct than that.

In commenting on policy in a European context I advised that it would be a good idea to have debt targets. It took six years to persuade the European Commission to take that on board, mainly because of political difficulties. That was not a case of telling people how to do something and what exactly their policy must be, but that was the bit that was missing from the design of the European currency union.

I could go further but, if you have read my written submission to the committee last summer, you will know that I have a fairly well-developed idea of what I think the fiscal commission should be doing, and you may take that up by all means.

The Convener: Thank you for that opening statement. I will ask a couple of opening questions, and I will then open the questioning up to colleagues.

You touched on this a bit in your initial remarks. Can you talk us through how you see the Scottish fiscal commission evolving? It is embryonic in terms of what it is going to be responsible for at the moment. However, one would expect the Parliament to have additional powers at some point in the years ahead. Where do you see the Scottish fiscal commission going?

Professor Hughes Hallett: That is certainly true. To start with it will be a comparatively simple matter, with just two taxes to consider—and they are not enormously big taxes. Because those two taxes are rather specific, how you forecast the revenues is not exactly the same as what you would do if you were considering the next one down the track, which will involve whatever part of income tax is devolved at the time.

The work of the commission will open up naturally from those small beginnings. It would be important to think about how far the commission wants its remit to expand, and about the cycle on which you want the various reports to come through. That means setting the rules of the game in advance. You will probably learn a lot about how best to do that from the experience of the two simple taxes. It is when the Scottish income tax component comes in that it will really open up.

A lot of other forces will impinge on that. It is not just a matter of calculating alpha times income levels, which are affected by other events in the economy. One has to take a slightly wider view. The rules of the game will evolve quite rapidly at that point. That would be useful as, if there is further devolution beyond that point, which is a possibility, you will have learned a lot about how to operate from the initial examples.

The Convener: In response to question 5 in the questionnaire, you emphasise:

> "I am a member of their Council of Economic Advisors on the condition that my independence would be protected, as it has been when opinions differed."

You make it clear that you provide advice or commentary only if

> "the independence of my analysis and advice can be honoured and guaranteed."

Professor Hughes Hallett: I agree with what I said.

The Convener: Yes—I was just wondering if you had anything further to add.

Professor Hughes Hallett: I do not mean to be facetious, but it is an important point. It is important in this context and it has been important in other contexts. You are quite right to ask that question—if I were in your position, I would ask it, too.

I emphasise the question of functional independence, as well as personal independence. If I am on the fiscal commission and I need to examine the revenues from such and such a tax, how they might develop in future, what is driving them, what can make them fluctuate and whether they are going to be embarrassing in the sense that they are going to collapse just when you need the money coming in, I want to be free to be able to do that in any way that I want. That is best practice.

I am happy to explain at any time how I have calculated something or why I think that such and such a point is a key feature. It requires a bit of a talent to explain that. It will probably not be very complicated for the existing taxes, but it will be very complicated for some of the others. If the income tax rate is changed, for instance, we have to explain whether the incentive is to work more to earn more, or whether it is to take leisure time. Those are income and substitution effects, to use the technical language. It is a matter of explaining to the outside world why we think that something is going to happen.

The models that you use may be very simple or a bit more complicated, and they have to be able to capture such things. I need to be free to use them.

I am skirting round one awkward thing: the OBR does not have quite the same freedom.

That said, those issues of independence are important. After that, everything is on a bit of a take-it-or-leave-it basis, unless life is getting really serious—which it will not for two small taxes, although it might do further on.

We point things out and the Government of the day can revise, change or ignore them. If the Government ignores that advice but we think that things are getting serious, we might say a lot more. That is a bit awkward in one sense—albeit not for the first few taxes. If you are monitoring a whole batch of taxes, you do not want to make incendiary statements such as, "If you do that, you'll be bankrupt by next week," because that will precipitate a financial crisis. You need to have the means to explain, if need be—first privately and then in public—why it is important to adjust things. All those things require commission members to be independent.

That said, the real reason for that independence, apart from the one that you are thinking of, is that the effectiveness of the commission depends on—how shall I put it?

The Convener: The perception that you have credibility?

Professor Hughes Hallett: Credibility—thank you. I was going to say having known intellectual standing, credibility and impartiality. I am not saying that for any personal reason—that is the case for genuine reasons. That is what gives the fiscal commission effectiveness. Short of that, it might give very good statements to which nobody pays any attention.

The Convener: I have a final point to make before opening out the questioning to colleagues around the table.

Initially, there will be a budget of only £20,000. Is that sufficient? Will that budget have to grow if your remit grows?

Professor Hughes Hallett: I am not in a position to tell you what to do. In the initial phases, it is fine. However, in a year or a year and a half, as the full force of the Scotland Act 2012 comes on stream, we would probably need to open it up a bit.

All three of us—I say "us", but I mean the three people—have other functions in life, and we do not have enough capacity to do a really large exercise if things become much more complicated. The important thing then would be to have a bit of budget that could be used to get some expertise from outside. That will be technical expertise, for example to run certain sorts of forecasts. We would specify some assumptions, the outside experts would turn the handle or switch the computer on, and we would then produce the interpretation and recommendations, such as they may be. Many fiscal policy councils work like that. They are relatively small and use outside help on the technical aspects. The budget will be important from that point of view and will expand at that stage. I can cost it for you but I will not do that right now.

Jamie Hepburn: Professor Hughes Hallett, I will ask about how you envisage the fiscal commission should operate. In your questionnaire, you say:

> "The first step has already been taken: the Commission is accountable to the Scottish Parliament, not to the Scottish Government."

You touched on that point in your opening remarks. Why is that important?

You go on to make an interesting point:

> "The second step is the Commission should operate according to comparative advantage."

You say a little bit more about that but, for the public record, will you say what you mean by that?

Professor Hughes Hallett: It is important that the commission is accountable to the Parliament rather than the Government. It is in the track record of fiscal councils elsewhere. Some of them are responsible to the particular Government but, of course, that allows the Government to put more pressure on them to take a particular line in the worst-case scenario.

For example, the Swedish one, which runs effectively, had a confrontation with the Government at one stage and won the argument. I know the people on it and would want to talk to them about their day-to-day experience. That instance is an important example of why the commission should be responsible to the Parliament rather than the Government. The Parliament represents the whole of Scotland whereas the Government may represent or get to represent a rather more narrowly focused agenda.

A fiscal commission cannot put the agenda on the Government—it must stay within the priorities that the Government sets as it is the elected Government—but, at the same time, it wants to be responsible for trying to carry out its responsibilities to the Parliament as a whole as best it can. If there is any difference of opinion, the opinion of the Parliament would matter rather than that of the particular Government.

I am afraid that "comparative advantage" is one of those phrases that I keep throwing out. When I got married, I had a long argument with my wife in which I argued that we should do it according to comparative advantage: I am better at earning the money; she is better at looking after the dogs. I mean the same in relation to the commission. There will be only three people involved, so it is important that they bring their own areas of expertise so that we can capitalise on them as best possible.

As I pointed out, one of the nominees is a modelling expert, I am the more general policy overview person and the chairman has specific experience of, and feel for, the business community and the financial markets, which is crucial, as it will be important in the commission's assessments, in the responses of the business community and the financial markets to those assessments and, indeed, in explaining the assessments to them and to the population as a whole, although that is slightly more open.

That is why I talked about comparative advantage. In principle, the set-up captures that. That is sensible. If, in 10 years' time, the thinking has expanded, the Parliament might want to look more closely at it and decide that it wants some other areas of expertise in the commission, but that is a long time ahead and I make no forecasts.

Jamie Hepburn: In your answer, you touched on engaging with other fiscal commissions. In your questionnaire, you say:

> "It would be valuable to establish regular contact with"

such bodies. Why is that important and how could such regular contact be established?

Professor Hughes Hallett: I imagine that it will take place at a much more individual level in the sense that, because we know people in another commission, we can talk to them about how they operate and whether they have learned something about operating procedures from which we might benefit in the Scottish fiscal commission. We could also ask them about their assessment not of their domestic economies but of the outside conditions—the world conditions. If we were going into a financial crisis like that of 2008, I would particularly want to know what some of the other commissions were thinking and how they assessed it.

I had those sorts of contacts in mind when I wrote that. It is easy, because it is not a big world. We know people.

Jamie Hepburn: That implies informal contact. Do you envisage some sort of formal arrangement?

Professor Hughes Hallett: This is a personal opinion, so it might not be adopted, but the obvious formal contact would be to use some people from those other commissions for the review that I mentioned taking place every five or seven years. They would have no particular interest or axe to grind in a Scottish context, but they would nonetheless have experience of how such things run, and of what is successful and what is not. They would know how to interpret the remit, and they could ask whether the commission has done what it should have done. They may be able to make some recommendations for operating in a different way.

10:45

At a formal level, that would be useful. It is a kind of accountability. The committee, or its successors, would obviously want to hold the commission to account, too, but you do not have the direct experience. You might find it useful to call in a couple of people to do that.

I have done such work, not for a fiscal commission but for the Dutch central bank. I was called in to review the way in which it operated and used its research, which was important in that case. The bank found an outside view to be very useful. That work was carried out at a formal level.

Jamie Hepburn: I was going to ask whether there was a precedent, but I suppose that you have answered that now.

Professor Hughes Hallett: That work did not involve a fiscal commission—we were talking about monetary policy—but the problems that the committee is considering are not a hundred miles apart from that.

Michael McMahon: Returning to question 3, on how you think the Scottish fiscal commission should operate, you state in point 4 of your response that

"as the financial crisis has made clear, fiscal deficits and difficulties often arise from pressures outside the fiscal arena"

and that you want the commission to have

"a watching brief over those factors".

You also say that you want the commission to look at the OBR forecasts. Do you set great store by those forecasts?

Professor Hughes Hallett: That is a leading question.

Michael McMahon: It is, yes.

Professor Hughes Hallett: The OBR is better than it was. Does that answer the question? When the OBR started, it was a bit off the map. I do not have a track record of the OBR's forecasts compared with the actual outturns—the OBR has been going for only three or four years. Obviously, the OBR will not be right, because all forecasts are by definition wrong. The question is by how much they are wrong, and whether there is a bias in them.

I know that the Treasury's record prior to the OBR's establishment was not stellar, which is why the OBR was created. It would be enormously helpful to know, privately, that the OBR is better than the Treasury was.

We can know some things. For example, the OBR made its first forecast for what it thought the revenues from the Scottish income tax would be; I refer to the publication that it produced in 2012. I know of only two such forecasts, and that was the first one. You can work out on a very simple basis what would need to go into the model to get those forecasts, and that implied that the OBR thought that the Scottish economy was going to grow 1 per cent faster than that of the rest of the UK. I would be delighted to see that, but I was not entirely convinced that that was reasonable. I must pass on making a judgment, because I am not really in a position to judge, but it is a good question and a good thing to look at—I might do so in my spare time at some point.

If the OBR is forecasting what is happening in the rest of the UK, it will have a lot of influence over what you would imagine will be the outcomes in Scotland and the revenues that are generated in Scotland. It is important to know that, but we cannot do anything about it. We might phone up and say, "Are you sure that number is the right one?". That is one of the inputs, which goes slightly wider than the two taxes that we are talking about right now as an exercise for the commission.

If I want to annoy a public audience, I put up a little formula so that they cannot get away without any algebra. There is an identity that tells us that the savings investment gap must equal the sum of the fiscal gap, which is spending less revenues, and the current account on trade—exports minus imports. Those are two things at each end—the savings gap and the trade gap—that will have an impact on the fiscal position.

Keeping a watching brief means taking note of what we think is happening in that regard, because it will have an impact; there will not be a whole lot of impact as far as the landfill and stamp duty taxes are concerned, although perhaps there will be an effect on the stamp duty one because it will have an effect on interest rates. I imagine that that would be comparatively small.

On income taxes, however, we would want to worry about these things: the conditions in the financial markets and the foreign trade sector. In Scotland, of course, however small or otherwise the North Sea oil revenues are, they still exist. That will matter at a future date. It does not matter for the taxes that we will consider at the moment, but it will come up, so we want a watching brief on that.

When I say "watching brief", I mean some understanding of what we would use to make the forecasts of revenues or changes in those sectors. It means not taking someone else's forecasts to pieces, but having some understanding of how reliable the revenues are and what direction they are moving in. It is not for the commission to challenge that—except in some really bad circumstances, in which it might want to make some comment—but to know what we think we should expect from those pressures on the fiscal balance.

Michael McMahon: Given that there will be only three of you and a budget of £20,000, will it be possible for the fiscal commission to be more robust in its analysis, and therefore provide a better model, than the OBR?

Professor Hughes Hallett: Oh, I should like to think so. It would be difficult to do it in detail. It is comparatively simple to get pretty robust forecasts. The problem is—again, you will think that I am being facetious—to know whether they are right, which means that one has to examine things in a little bit more detail, look a bit deeper and challenge one's own calculations, which, in the circumstances, would be fairly back-of-the-envelope calculations.

Some of the numbers that appear in my evidence for the next agenda item are not forecasts but back-of-the-envelope calculations. I reckon that they are probably pretty good but, to be really sure, I would need to go into greater detail. That is where the problem comes. That is why I said that, in more complicated circumstances, the commission might want to buy in some expertise from outside.

Gavin Brown: Question 5 in the questionnaire asks:

> "Do you hold any other roles … which might give rise to or be perceived as being a potential conflict of interest"?

How do you deal with having a role on the Council of Economic Advisers, where you advise on a number of issues, including—according to the annual report—economic levers while, at the same time, having a scrutiny and challenge function on the application of at least some of those economic levers?

Professor Hughes Hallett: As I said in response to the convener's question on the same matter, it is right and important that you should ask that question. I do not perceive any particular conflict of interest in the sense that, on the Council of Economic Advisers, we might discuss certain policy options in a general sense, but we do not set a policy. We do not say what tax rates should be. We do not even say that we should use one tax rather than another. We might say that it would be advantageous to consider the possibility of using a certain tax more generally.

The areas in which conflicts of interest might come up have not come up. That is the way that the council operates. The advice takes the form of asking whether the Government has thought about a particular approach rather than anything prescriptive or proactive, so I do not envisage there being a conflict.

Because the council is independent, it knows that it is independent and it is agreed that it is independent, the advice is given on a take-it-or-leave-it basis. We ask, for example, whether the Government has thought about the possibility of supporting research and development in the high-technology sector, which is one of the ones with which I was concerned. We do not say to the Government, "You must do it like this," so it is not that we say definitively that, in our judgment, the Government must follow a particular policy.

We are independent and it is difficult to imagine how somebody who is independent can have a conflict of interests, because they would not then be independent. The council is not beholden to anybody, nor do I imagine the commission would be—anyway, I would not want to be.

As I said before, the fiscal commission does not and should not involve any policy advocacy either—that is separate. I regard the roles as much more complementary. Whether or not I am in the Council of Economic Advisers, somebody on the council needs to have the forecasts. If the advice is that there is a need to think about how taxes are unfolding because, if we go too far, they will get unsustainable, or something of that kind, the council needs to have an understanding of the forecasts that have gone into that. I would feel rather uncomfortable if there were not people on the Council of Economic Advisers who were able to provide that or who had that information with them.

It is not so much a conflict, in which the person concerned feels that they might have to say one thing at the council and another at the commission. It is sequential. That is what makes the roles complementary, and that is how I view them.

There have been cases—not in Scottish matters—where I have been involved in this kind of policy analysis framework, and where conflicts have arisen and someone's independence has been challenged. The receiving party said that something must be changed—calculating the conversion factors for currencies going into the euro—and that led to a parting of the ways. If someone gets locked into a case where there is a conflict, they must decide which way they are going to go. Will they keep one role, keep the other or, possibly, not do either? I do not foresee that happening at all in this context, but that would be the outcome if it did.

Gavin Brown: In your role on the Council of Economic Advisers, have you ever advised the Government or discussed with it the setting up of the Scottish fiscal commission?

Professor Hughes Hallett: Yes. I refer to the paper outlining what fiscal commissions in the rest of the world do and what I thought the framework should be. It is up to the Government to accept it or not. That sounds like a take-it-or-leave-it basis. In this case—as I am here—the Government obviously took it.

It is like giving a sketch. I am sorry for being pedantic, but it is like asking a student what the problem is, how they would solve it and what the advantages are, and then asking them to provide an outline of how their solution might work. It is entirely up to the Government whether it likes it or not. The model that the Government had in mind is not exactly the same, as it turns out, but it is the Government's prerogative to do that. I am saying how we might imagine the arrangements might work and I am providing a set of examples of how things work elsewhere. That provides a range of possibilities, and the Government chooses.

The word "conflict" suggests that there is an adversarial arrangement, but there is not. The arrangements are in evolution. That is how they work.

Gavin Brown: Can you see how there might be a perception of a conflict between somebody advising Government on economic levers and somebody having the challenge function on the application of those economic levers?

Professor Hughes Hallett: The fiscal commission can challenge the forecasts that are being used. It can say that if the work had been done properly, that would have produced different numbers, which should be taken into account, as opposed to saying that the policies that the Government plans to pursue are wrong for some reason and that it ought to be pursuing other ones. The commission will not ever do that. There is no role for policy advocacy; it is a matter of asking whether certain things have been thought about.

I do not find that to be conflicting with what the Council of Economic Advisers might say. It might say that, on the basis of a certain factor, there is a possibility that the economy will be damaged if a certain policy is pursued, so it could ask whether other possibilities had been considered. It is up to the Government to take that up or to reject it.

Gavin Brown: I will leave it there.

Malcolm Chisholm: You say that the Council of Economic Advisers does not set policy, but were you not on the working group that came forward with the advice on monetary union?

Professor Hughes Hallett: There is a distinction between the policies and the framework, and this is a framework issue. I am talking about institutions and monetary arrangements, in that case. We are not in a position to say what the Government should adopt. We might say that, on the basis of the analysis that we or most other people would carry out, one option seems to be the most sensible one and that the Government should think about doing that. It is entirely up to the Government to take it or leave it.

11:00

Malcolm Chisholm: I observe that your group is the primary source that is invoked when that policy is defended.

Professor Hughes Hallett: Right, but you have to read carefully what we say. I take Mr Brown's point. Other people might think that we say other things.

Malcolm Chisholm: I do not know whether you have seen Bill Jamieson's rather long article about the issue this morning. He talks about the two roles as

"running with the hare and hunting with the hounds",

which I suppose is another way of expressing Gavin Brown's point. There are obviously significant concerns.

Professor Hughes Hallett: There is a perception there. You must be a little bit careful not to view this as Lenin would have done: that those who are not with us are against us. In the current atmosphere, that happens rather easily. My argument is not about hare and hounds; the roles are complementary. One uses information from the other; each is independent and uses it in the way that they think is best.

Malcolm Chisholm: I certainly do not want to be compared to Lenin, which would not be very desirable.

Professor Hughes Hallett: It is not you—it is about the perception.

Malcolm Chisholm: Your fundamental point was about functioning independence being more important than political or personal independence. You can see why people might be concerned about the latter as well as the former.

Professor Hughes Hallett: Sure. I do not want to underplay that. When I say that, I am doing it to emphasise the functional independence, as that is the unusual part in this context. In another case, the emphasis is on the personal and political aspects. It is not that they do not matter; it is just to make the point.

Malcolm Chisholm: Is Bill Jamieson wrong to call you "a prominent SNP sympathiser"?

Professor Hughes Hallett: I take no view. I should make it clear on that particular issue. I anticipated that you might ask, and you have not done so, but you have got close to it. I take no view—I just consider the economics and I say what the logic says.

Malcolm Chisholm: We will come to today's main evidence session in a moment, but you would accept that your views are rather more aligned with the SNP's views than with those of people who are opposed to independence.

Professor Hughes Hallett: I would accept the view that my views are a little bit more realistic than many others.

Malcolm Chisholm: We shall pursue that further.

Professor Hughes Hallett: I am sure you will.

The Convener: Is there anything else that you wish to say before we wind up this session?

Professor Hughes Hallett: No—that is fine with me at this stage.

11:02

Meeting suspended.

11:10

On resuming—

Scotland's Public Finances Post-2014

The Convener: Agenda item 4 is consideration of Scotland's public finances post-2014. I welcome to the meeting Professor Hughes Hallett, once again; Gemma Tetlow from the Institute for Fiscal Studies; and Ben Thomson from Reform Scotland. As members have received copies of the witnesses' written submissions, we will go straight to questions. We are fairly pressed for time this morning, so I ask each member—I include myself in this—to restrict his or her time for questions to no more than 15 minutes. I hope, therefore, that questions and answers will be fairly brief. I am going to be quite strict about that, as we need sufficient time to deal with item 5, which is consideration of a draft report. However, if I put a question specifically to one of the witnesses, the other witnesses should, if they so wish, feel free to add their own comments after the person in question has responded.

Without further ado, I will ask the first question, which is for Professor Hughes Hallett. On the first page of your submission, you talk about currency and say that

> "the outcomes for Scotland in the absence of cooperation, concessions or formal currency union would show a considerable improvement of her current (status quo) position; whereas rUK would inevitably suffer worse economic outcomes"

and that

> "the only difference would be that Scotland gets to add tax powers to the existing monetary set up"

and

> "would ... be unambiguously better off: more policy instruments to serve the same targets—instruments that can now be designed to fit Scotland's specific needs, rather than the UK average."

In what ways would Scotland benefit? Your colleagues, too, can comment if they so wish.

Professor Hughes Hallett: If we are just going to talk about the currency union—

The Convener: Not specifically. I want to get the witnesses' views on currency issues, and then I will move on to one or two other areas before I open out the discussion to colleagues. I will not be able to cover all the areas in the short time that I have, but I hope that my colleagues will pick up other issues. I am specifically asking why your position on currency is as it is.

Professor Hughes Hallett: In my submission, I make a distinction between full currency union and what would formally be described as a unilateral position—I think that people call it sterlingisation—in which you simply take the currency but you are not in the kind of union in which you have input into monetary policy making. If Scotland has input into such policy making at the margins, the monetary policy will be a little bit more suitable for Scotland than it would otherwise be, so there is a gain in that respect. Otherwise, if you sterlingised, the monetary policy would be exactly the same as it is now. We are in a currency union at the moment; it is just that it is unilateral and we have no input into policy.

With Scotland as an independent but sterlingised unit, the difference from the status quo is that Scotland will have control of its own taxes and will be able to make them fit its own circumstances instead of having to meet some UK average. As a result, it must be better off: the monetary policy will be the same, but the fiscal policy will produce better results. The obverse of that for the rest of the UK is that although the monetary policy will be the same as at present, it will not have as many tax revenues as it had before because the Scottish bits will have been taken out. It might also find that the way in which Scottish taxes have been set is not as suitable as in the past. On that basis, RUK will be worse off.

Ben Thomson (Reform Scotland): I apologise to Andrew Hughes Hallett, but I think that he is confusing taxation and monetary union. There are significant difficulties with sterlingisation. First, if you have sterlingisation instead of proper monetary union, you do not get the ability to print money; in fact, if the host nation that controls the currency prints new money, all that money will be distributed in its own geographical area and nowhere else. Secondly, you have no control over interest rates. The ability to set and control such rates plays a large part in fiscal stimulus and lies with the regulatory bank of the zone in which the currency is issued. The significant difference, therefore, between sterlingisation and being part of a proper monetary union is that you do not have the influence, through the Bank of England, to do what you can with your currency.

The second thing on which I disagree with Andrew Hughes Hallett is that I think that you can have separate tax policies with some degree of fiscal harmonisation within a currency union. I do not think that you need to be separate and have sterlingisation in order to have a completely different tax system.

The Convener: I will let Professor Hughes Hallett back in, but not until Gemma Tetlow has spoken, if she so wishes.

11:15

Gemma Tetlow (Institute for Fiscal Studies): Like Ben Thomson, I slightly disagree with Andrew Hughes Hallett's characterisation of the situation under sterlingisation. At the moment, the UK is a single country. Monetary policy is set for the whole country, and the fiscal transfers that happen between regions act as automatic stabilisers as the economies of those regions evolve. If there were a formal currency union between two separate countries or if Scotland had informal sterlingisation, the situation would be very different. Scotland would be a separate, independent country with a very different economy from that of the UK. For example, an independent Scotland would be a large oil producer and exporter, while the UK would be a large oil importer; Scotland would be subject to different economic fluctuations and a different fiscal position from the UK as a whole; the UK would set monetary policy to suit its own circumstances; and Scotland would lose the monetary policy lever because it would peg itself to the pound. As a result, all adjustments to deal with economic shocks would have to come through fiscal policy.

An independent Scotland's ability to do that would depend on the level of debt that it started with. Would it be able to borrow significantly in years of low oil revenues to try to smooth out those economic fluctuations? Compared with the current position, sterlingisation would incur costs for Scotland.

The Convener: So you would be in favour of a currency union.

Gemma Tetlow: I am not advocating any of these policies; I was simply clarifying the point that it is not "unambiguously" true that under sterlingisation Scotland would be at least as well off as it is at the moment.

The Convener: I will let Professor Hughes Hallett wind up on this point.

Professor Hughes Hallett: We could argue for hours about this—and we probably will—but I will be quick. I point out that all the costs that have been mentioned are costs that are associated with not being in a full monetary union in which you can influence policy. It is perfectly true that a monetary union is a better situation. I am making a comparison with the status quo. Can Scotland print money at the moment? No. Can it have its own interest rates? No. The lack of transfers, which, as has been pointed out, act as automatic stabilisers, would be replaced by having control of our own fiscal policy—it would be sterlingisation with fiscal powers. Otherwise, we would have no influence over monetary policy. Being in a full monetary union would certainly be better, because you would have influence over monetary policy;

indeed, that is why the fiscal commission working group recommended it. My point is simply this: sterlingisation would leave Scotland better off and RUK worse off.

The weak point about sterlingisation, which no one has picked up yet, is the lack of a central bank. That might not matter in itself, but it will matter to liquidity provision for the banks and financial regulation, and the sterlingisation option would have to be supplemented by an opt-in to another banking union if London said, “You can’t be part of our bank.” In that event, it would be perfectly possible to opt into the EU version.

The Convener: I want to ask Gemma Tetlow about debt, and quantitative easing specifically. The IFS submission talks about projections suggesting that Scotland will have a higher debt burden—or, I should say, a bigger fiscal gap—if it becomes independent. What is your view of Dr Jim Cuthbert’s comment on that issue? He told the committee:

> “Even if it is not assumed that Scotland will be debt free, if we bring in the quantitative easing point and the defence point, the fiscal deficit is probably overstated by something like 2.3 or 2.5 per cent of GDP.”—[*Official Report*, *Finance Committee*, 30 April 2014; c 4043-4.]

I also note that in your submission you have assumed that Scotland’s expenditure on defence will be exactly its UK share, whereas Professor Hughes Hallett has suggested that expenditure would be less than 6 per cent. The gap, therefore, between what could be spent and what is being spent is considerably higher.

First of all, though, could you respond to the point about quantitative easing?

Gemma Tetlow: Can I clarify what your question was?

The Convener: Let us deal with quantitative easing first, and then we will go on to the other issue, which relates to what you said in your submission about Scotland’s expenditure on defence falling from about £2.9 billion to about £2.5 billion, effectively freeing up about £400 million of expenditure. That assumes, does it not, that around £2.9 billion to £3 billion is currently being spent on defence in Scotland, whereas Professor Hughes Hallett’s figures suggest that only around £1.8 billion is being spent on defence, so more money would be freed up to spend on conventional weaponry or something completely different.

I am sorry: I should have separated out quantitative easing. I want you to focus on quantitative easing first.

Gemma Tetlow: Was your question on quantitative easing that, currently, part of the gilts that are issued by the UK Treasury—

The Convener: Basically, Dr Cuthbert argued that it is not real debt, because it recirculates within the Treasury. Therefore, it would be inappropriate to expect Scotland to accept that as a burden of debt in the negotiations post-independence, as it is not real debt in the UK’s overall debt burden.

Gemma Tetlow: As I understand it, the intention is that quantitative easing will be unwound at some point, when the Bank of England thinks that tighter monetary policy is required. Therefore, although those gilts are currently held by the Bank of England, which is part of the public sector in the UK, the intention is that they will be sold back to the private sector at some point. When they come up for redemption, they will have to be paid off, so there is a commitment to pay those debts at some point. I think that they would be considered alongside the existing stock of UK debt. Obviously, what the negotiation would be between an independent Scotland and the rest of the UK is an open question.

The Convener: You are basically saying that Scotland should take its share of that quantitative easing debt, but Dr Cuthbert’s point was that that debt does not really exist in the UK’s overall debt burden.

Gemma Tetlow: As far as I understand the Bank of England’s position, its intention is that quantitative easing will be unwound, but exactly when that will happen remains to be seen.

Ben Thomson: I am not sure that I totally agree with the Bank of England’s statement that quantitative easing might be unwound. I think that everyone thinks that it is quite likely that it will not be. The Bank of England has printed about 40 per cent of gross domestic product in quantitative easing. If the gilts are cancelled, the effect will be the same as printing money. I know that people do not like the phrase “printing money”, but, in effect, if that approach is taken, it is printing money.

It is interesting that you can do that only if you have your own currency. Unless Scotland has its own currency, it cannot do quantitative easing, as it would need its own currency to be able physically to do that.

I think that it would be assumed that, as part of any negotiation, there would be a debate about all the liabilities that the UK Government currently holds, which would include the physical level of debt, quantitative easing, pension liabilities and private finance initiative and other contingent liabilities. If there is a yes vote, there would need to be a debate and argument about each of those and what Scotland’s fair share of them should be. I suspect that the debate about quantitative easing would be around the likelihood that it will never be repaid—this is about printing money rather than letting the gilts come back out into the market again.

Professor Hughes Hallett: I am not sure that I want to enter very far into this. I agree with Ben Thomson that we would expect Scotland to get its share. We could think about net debt rather than gross debt—the quantitative easing would be taken out before negotiating. In principle, I understand what people are saying, but I have no idea what I would make of the numbers and I do not know how big Scotland's proportion would be.

It is not true to say that you cannot have quantitative easing unless you have your own currency. In principle, you can buy any assets that you like. Whether that is wise is another matter, but it can be done—it is perfectly possible. Without a central bank, it would be a bit difficult to have a repository for that, but there would be a debt management agency that could run surpluses. Australia used to do that and Hong Kong does it, so the point is not so important.

The Convener: If quantitative easing was taken out, Dr Cuthbert estimated an overstating of 2.3 to 2.5 per cent of Scottish GDP. That would reduce the fiscal deficit by that amount. Is that a reasonable ball-park figure?

Gemma Tetlow: To be honest, I tend to agree with Ben Thomson. I think that, at the point of independence, if it happened, there would be a wide-ranging negotiation on the allocation of existing assets and debts between an independent Scotland and the UK, and that would be one, fairly small part of that picture. Obviously, things would depend on a lot of other negotiations.

The Convener: Okay.

On my question about defence, which I ham-fistedly added to my question on quantitative easing, how did you get to those figures? My assumption from looking at your figures is that you just took Scotland's share of the UK's defence expenditure rather than what was spent in Scotland. Is that correct?

Gemma Tetlow: The £2.9 billion figure for 2015 used the same methodology that the Scottish Government uses for "Government Expenditure and Revenue Scotland". It essentially assumes that UK defence spending benefits every person in the UK by the same amount, wherever that spending occurs.

How much each person across the UK values the defence that is provided is a difficult question to answer. It is not unambiguously clear that only defence spending that happens in Scotland is for Scotland's benefit; some defence spending that happens elsewhere may also benefit Scotland because it secures the nation and ensures that you are not open to other threats.

Your question is a difficult one to answer. The £2.9 billion is one number. We have compared that figure with the £2.5 billion that was outlined in last November's Scottish Government white paper. That is the basis on which we said that the ball-park saving figure was around £400 million.

The Convener: Professor Hughes Hallett, on page 5 of your submission, you said:

"currently Scotland raises £3bn for defence, but only £1.8bn of that is spent in Scotland. So spending £2.5bn would both save £½bn"

for spending elsewhere

"and increase Scottish defence efforts by 35%."

Is there anything further that you want to add to that?

Professor Hughes Hallett: That is virtually the same amount of savings that Gemma Tetlow mentioned—my £500 million against her £400 million. That would be a lot in my bank account, but in context the amount is very small.

Ben Thomson: I have nothing to add to that.

The Convener: I will move on to Ben Thomson's paper. You have given detailed explanations on your figures on taxation and borrowing of how Scotland could benefit through devo plus. Will you talk us through those explanations? I will then allow the other witnesses to comment.

Ben Thomson: Funnily enough, I was at this committee four years ago considering how we could address the deficit. At the time—the information on 2009-10 spending is in my chart in the paper—we were spending in the UK and in Scotland 30 per cent more than we were raising in taxes. That was a significant problem, irrespective of whether you were in Scotland or in the rest of the UK. Spending 30 per cent more than we were raising in taxes was not a good position to be in.

I said at the time that the Scottish Government was tinkering with the issue; it was considering how to make efficiencies of £3 billion, which would not, in the grand scheme of things, get you very far. I said that we needed a culture change in the UK and in Scotland to make public services more efficient and effective and to recognise that things were not working in the whole UK. Part of the problem lay in having a very centralised process whereby Westminster was responsible for raising more than 90 per cent of all taxation while local and devolved government were responsible for spending the majority—about 60 per cent—of that.

We proposed that the majority, if not all, of what each level of government spends be raised at that level of government. That forms the basic philosophy of devo plus; each level of government—local government, Holyrood or Westminster—should be broadly responsible for raising what it spends. That would create a real culture change in our public services that might address the deficit, which remains at 20 per cent—we are spending 20 per cent more than we raise. That would also give people greater accountability and it would mean that taxes and welfare would be better shaped to service an area—the local community and environment—than a centralised and very bureaucratic system would be. Therefore, we proposed devo plus.

11:30

As you can see in our paper, we have tried broadly to match what is spent in Westminster with Westminster taxes—namely VAT and national insurance. Those taxes would be reserved while most other taxes would be devolved down to Scotland. That would allow Scotland, on the current basis, to raise about 75 per cent of what it spends. We highlighted the taxes in our report, so I do not necessarily want to go through them. The reason for keeping VAT and national insurance at Westminster is that VAT cannot vary within an EU country.

We think that pensions and work benefits should remain UK expenditure, and given that national insurance is supposedly linked to pensions—even if the link is sometimes a bit tenuous—it would be sensible to leave that tax at Westminster level.

However, the ability for local and devolved government to track their local economies and to change and vary taxes better to suit the local environment and culture would change the culture.

I will not go through much more of the report, which I think sets out our philosophy. I am happy to take questions on it.

The Convener: Okay. I take it that oil and gas would not be included and would remain with Westminster. What would be the impact of your proposed approach on Scottish public expenditure?

Ben Thomson: To start off with, there would be no change in the figures: total public expenditure in Scotland is £65 billion, whether Westminster or Holyrood spends it and whether or not we are independent. I think that everyone is working with the same figure of £65 billion, which was the total level of public expenditure in Scotland last year. The figure is currently split thus: £38 billion is the responsibility of the Scottish Parliament through its budget—through the Barnett formula, council tax and business rates—and the rest of the spending is Westminster spending.

The Convener: Basically, what you suggest would just ensure greater responsibility and accountability at Scotland level.

Ben Thomson: It would also do that for the local government level, which is important. We see the debate as being not about nationalism but about a new union between the various levels of government, in order to make each level more effective and efficient. That would be good for Scotland and for the UK, both of which are running considerable deficits that are not sustainable in the long run. We cannot run a country, even at today's levels, in which we spend 20 per cent more than we raise in taxes.

The Convener: How would you close the gap?

Ben Thomson: That would require the change of culture that I talked about. Each area must be made to feel responsible and must become engaged in solving the problem. At the moment, the Treasury receives everything and everyone else is incentivised to spend budgets as far and as fully as they can, which leads every March to what I call the traffic cone syndrome, when local government tries to spend its budget and justify why it should have the same amount, or more, next year. We have to turn that culture round and create an environment in which people ask how they can tax the people in their area in the most suitable and effective way, and match that with provision of the best possible public services, which the people want.

If we look at the Scandinavian model—as I know some members rather like doing—we find that the reason why it works so well is not because it has a high level of public services, but because it takes things right down to community level. There is much more local and community engagement. That model is an example of how to increase responsibility and accountability at local level, which leads to efficiencies right the way through the system.

The Convener: Would taxes have to go up or services be reduced to close the gap?

Ben Thomson: It is obvious that services have to be made more efficient. If we are spending 20 per cent more than we raise in taxes, something has to change. We have to grow the economy, raise taxes or decrease expenditure. Those hard choices are what politicians are there to make. However, politicians at each level of government do not currently have the tools to make such choices; everything goes into a very centralised Westminster and then comes back out of it.

All the parties have recognised that. We have had commissions from Labour, the Conservatives and the Liberal Democrats, all of which advocate greater fiscal and welfare powers. The Scottish National Party and the Greens also advocate greater powers. I think that everyone recognises that decentralisation is a positive and healthy development for Scotland and for the rest of the UK.

The Convener: Do other panel members wish to comment?

Professor Hughes Hallett: I do not in principle disagree at all with what Ben Thomson said. He is advocating decentralisation; that makes perfect sense, as long as we are talking about the fiscal sector only. He and I are separated only by degree—in my case, for strategic reasons that do not really come into today's discussion.

The only thing that I would say is that the numbers are confusing. First of all, I find it hard to understand a lot of the things that are published about how big the underlying deficit gap would be, because they often do not specify whether we are talking about the entire fiscal budget or the current-spending part. Secondly, they always quote figures as a percentage of GDP, but it is hard to run to earth exactly whether they are talking about total GDP, as you would calculate it for an independent, autonomous or federalised country. We get different numbers coming out.

By contrast with the 30 per cent gap with which Ben Thomson started, and I think that he mentioned 20 per cent at the start of—

Ben Thomson: In 2009-10, yes.

Professor Hughes Hallett: The alternative is that Her Majesty's Revenue and Customs says that the revenues raised in Scotland are 10 per cent higher than the spending per head. That sounds like a surplus to me, and it is the same number of heads. You can take that calculation and work out how that happens, and you will find that the revenues include things such as North Sea oil. We can argue about the numbers, but you know what the revenues were at some point in the past and you can take that number and recalculate how much of the North Sea oil revenue that is coming into the Treasury in London is recycled to Scotland, and the answer is that typically around 60 per cent; up to 40 per cent goes to other things.

That is why there is confusion in the numbers and a gap. It is a common accounting problem; my university in America has real problems with it. What is coming into the university is its revenue, what it spends to keep the section that I am in afloat is our costs; the university does not want to close it down because it does not understand why the revenues and the costs are different. To look at it the other way round, identifying a savings gap, a fiscal gap and a foreign trade gap has to hold, since the Moody's report was kind enough to give estimates of Scotland's trade gap. You can put oil into that and see what all the exports are to RUK and other countries, and you will find that with the reported fiscal gap and the reported trade gap we have GDP savings about 16.5 per cent higher than investment.

One of two things must be true. Either the numbers that are being used in that context are wrong, which I suspect to be the case, or we are being fleeced. It is one or the other, so I am doubtful about the numbers, although the argument is fine.

Ben Thomson: The numbers are clear to me, and I am happy to explain them to anyone who wants an explanation. Reform Scotland has now done 10 different reports on the subject and on devo plus, and I am more than happy to justify the numbers to anyone who has any questions about them.

The 30 per cent is a simple number. It takes what the UK raises—or raised in 2009-10—in revenue and divides it by the amount that it has as the deficit, which are published figures. It is not doing it on a GDP basis, because the Government is responsible for raising money and spending money. It has nothing to do with the underlying economy.

If anyone wants me to go through the numbers afterwards, I would be happy to do that.

Professor Hughes Hallett: My point about the university was that the university was doing the same and that it now has a financial problem.

The Convener: I have already overrun my own time, so I would like to give colleagues the opportunity to touch on some of the issues.

Jamie Hepburn: I will pick up the issue of currency union. Professor Hughes Hallett's paper states:

> "After the referendum, there will be no incentive for either side not to agree a currency union as long as effective fiscal controls are put in place on both sides to restrain the growth in public debt."

David Simpson also pointed out that there would be restraints on both sides. Your paper goes on to say that

> "Since, by all measures, the Scottish fiscal position will be stronger ... this would not be hard to arrange."

Can you expand on that?

Professor Hughes Hallett: Fiscal restraints will be necessary. They will be necessary in any context: you do not want to run a system in which the legislative authorities are irresponsible—even if you are Greek. Fiscal restraints make sense in a currency union because monetary policy will be a compromise that will not necessarily suit each party optimally, therefore there would be more use of fiscal policies, which would need to be restrained in case they became unsustainable and too ambitious.

My point is that there will be fiscal restraints on both sides. I specify that because the rest of the UK could do far more damage to Scotland than Scotland could do to the rest of the UK. It will be very difficult to persuade the rest of the UK, but fiscal restraints will be necessary on both sides.

I have forgotten your second point.

Jamie Hepburn: My second point was your point, actually.

Professor Hughes Hallett: I have forgotten my point, too.

Jamie Hepburn: The point was that putting the arrangements in place would not be hard to arrange.

Professor Hughes Hallett: It would not be hard to arrange on the Scottish side but, as I just said, it might be very hard to persuade the rest of the UK to abide by fiscal rules—at least in current circumstances.

I stress: it is one thing to have fiscal rules, but another to enforce them. You can make a comparison with the eurozone, where the problem is enforceability, or the lack of it, rather than the fiscal rules themselves. As I said in a previous evidence session, I would design the rules differently, but the problem is that they have to be enforced and to be seen to be enforced, otherwise everybody will game the system—which is exactly what happened in the eurozone.

Ben Thomson: Let us be clear. If we have a yes vote and a monetary union is put in place, we have to set up a monetary union treaty. Like Maastricht, it will be a bureaucratic civil servant's delight, and all the lawyers will be in there.

The treaty will have to set out how the monetary union will work. It will have to set out what we do about a central bank and how we regulate the banks. It will have to set up a committee to look at the economy across both countries in order to determine interest rates and the issuing of new money, and how the new money will get divided. It will be necessary to sort out a series of issues in a treaty.

The treaty will also have to cover what happens if it does not work: the arbitration measures. Within that, there will have to be fiscal control. Eventually, it would probably use something like Gordon Brown's golden rules, which were that borrowing should not go over 40 per cent of GDP over the long term, that we should not run a deficit of more than 3 per cent and that, over the cycle, we should not have a deficit at all. Those are great aims to have, and they will have to be built into the treaty in exactly the same way as the rules were built into the monetary union treaty of Europe.

The question I have is whether a treaty is the better way to do that, compared with having democratic representation. The debate is happening in Europe just as it is happening here. If you are going to be part of the eurozone, is it easier to do it with a treaty—and all the difficulties and adjustment that go alongside it—or through political representation, with which everyone has a bit of give and take and knows that they have the ability to argue things through the ballot boxes, at a certain stage?

That sets out the answer to your question. After a yes vote to monetary union there will be a complicated treaty, which will have to deal with all those things. It will be difficult to negotiate, but it will be perfectly possible to negotiate.

Jamie Hepburn: Professor Hughes Hallett's paper talks about start-up costs for Government departments and agencies. You summarise the boorach of Her Majesty's Treasury's attempts to estimate the costs, and you go on to say:

> "they are one off costs and therefore not to be repeated in later budgets; they are also gross costs, not net. Meaning that the current (imputed) payments to the UK government for those services must be subtracted off first, so the actual net cost would be quite small".

Can you talk a bit more about that?

Professor Hughes Hallett: That illustrates the difference between the numbers that the Treasury talks about and what the authors of the report to the Treasury say the real numbers should be. The Treasury is looking at the figures on a net basis, so it has taken out the savings. If you set up a new ministry or agency to do something or other, to the extent that it was done at the UK level, you will have to pay for that—this is in the independence case only, not the autonomy case—but first you will take out what you have been paying for it at UK level, so the net expenditure on such things will be less. One of the authors of the report talks about £600 million and the other is talking about £200 million, so the cost will be somewhere in that range.

Those are set-up costs, but there are obviously running costs as well, although we pay running costs at the moment. I assume that the leverage is such that it can be imputed that the population share will remain the same. That is why the set-up costs are not repeated.

My point was that the figures of hundreds of millions of pounds that have been mentioned sound like large sums of money, but that is only because we think of them in terms of our own bank accounts. In the grand scheme of things, they are actually very small. As I said in my submission, those costs could be paid for, as it were—you would not necessarily do this; I simply use this as a way of framing the discussion—over four months; paying off £600 million would take 1 per cent off the growth rate, which we are told will be 3 per cent over that period. It is not a cost to worry about; it is comparatively small.

11:45

Jamie Hepburn: In a nutshell, you are saying that the Treasury is pretending that Scotland does not already contribute to those services at UK level.

Professor Hughes Hallett: I assume that that is what it is pretending; I would not dare to put words in the Treasury's mouth. It is not I who said those things, by the way, but the authors of the reports that the Treasury is using to justify its numbers.

Gemma Tetlow: Professor Hughes Hallett is correct to say that we are talking about a one-off cost. Therefore, what we want to think about is the annualised present value of that cost, rather than the whole number. I presume that the running costs of such organisations will be similar to the current spending allocation for Scotland; some of the costs of running Whitehall departments will be allocated to an independent Scotland. The running costs will probably not be very much changed.

Notwithstanding the great degree of public debate that there was about the precision of the numbers that were in the Treasury paper, that element of the cost of an independent Scotland was a very small part of the bigger picture that the Treasury paper set out. Whichever number you believe—I have not read the underlying research in detail—that was quite a small part of the bigger issues that were set out in the Treasury paper.

Jamie Hepburn: I presume that the authors of the underlying research that the Treasury drew on, and who have said that the Treasury was wrong, are aware of their underlying research.

Gemma Tetlow: They certainly would have been. It was unfortunate that their numbers were used in an incorrect way.

Jamie Hepburn: One could call it "unfortunate", I suppose.

In relation to on-going costs, there is a presupposition that nothing would change, but Professor Hughes Hallett makes the point that tax collection in Norway and Finland costs 50 per cent less per unit of revenue raised than it does in the UK. Adopting their procedures could perhaps save £400 million, so it is not necessarily logical to draw the conclusion that the services in question, were they being run from Scotland, would cost exactly the same, is it?

Gemma Tetlow: I know absolutely nothing about how Norway collects its tax revenues. Clearly, it would be an option for an independent Scotland to do things more efficiently than the UK as a whole does them, and that would certainly have a benefit.

Jamie Hepburn: Ms Tetlow and Mr Thomson both highlight an area in which it would be fair to summarise your position by saying that you hint at the limits of devolution. The IFS paper states:

> "under the present devolution settlement, the Scottish government is bearing the cost of greater investment in social housing and lower rents, whilst some of the benefits of that spending accrue to the UK government in the form of lower housing benefit payments."

In relation to tackling poverty here in Scotland, the Reform Scotland submission says:

> "the ability of the Scottish Government to address this problem is seriously hampered because the main levers by which to address it are held by Westminster, leaving the Scottish Government only able to tinker."

Although you refer to different issues, you both highlight the limits of devolution. Why did you raise those examples?

Ben Thomson: Dealing with poverty is a central and key concern of what government should be about. Reform Scotland has always held the view that alleviating poverty should start locally, and that not having all the tools that it needs to create an environment that will alleviate poverty hamstrings local government.

We see most welfare benefits being passed down to Holyrood and then to local government. That is the point at which we can alleviate poverty. It means that local government can then create schemes that get people back into work, and deal with poverty, because it has the tools of benefits and spending powers.

More than that, local government can have clarity about services. Local policing, local healthcare and local education are all necessary ingredients in addressing poverty, and they are all handled at the same level of government. The problem is that many things are done at other levels of government: welfare is split from fundraising, which is split from expenditure, which is done in different areas, all of which means that no one can create holistic solutions that are right for their particular area. We are trying to get the right tools at the right level of government so that we can address the problem. We want to address poverty, in particular, at community and local government level.

Gemma Tetlow: Ben Thomson's work covers the subject in a lot more detail than ours does, but one potential benefit of independence would be that the Government would have much greater flexibility to prioritise spending in a way that matches the priorities of Scottish voters. Where Scotland has had the power to decide on its own spending in recent years, it has made different decisions; provision of social housing seems to be one of the areas in which considerably more is spent in Scotland than is spent in the rest of the UK.

However, I do not think that that issue affects only devolution to local government; it also affects the division of spending across Government departments in Whitehall. For example, if the DWP puts effort into getting people back into work, that reduces levels of benefits spending and increases tax revenues to the Treasury, but the DWP does not get any benefit to its budget that it could spend on other priority areas. That arises across Government spending areas; similar issues would arise elsewhere.

Jamie Hepburn: It is not quite right to compare independence with what happens with departments in the Government. I presume that the DWP would be quite happy to see more people in work, a reduction in the welfare bill, and more taxes accrued. I am sure you would accept that the two are not the same.

Gemma Tetlow: The situation is different, but the incentives are the same if we are saying that decision-makers at a more devolved level do not have the right incentives at the moment because they do not see the full benefits of their efforts. That kind of issue arises elsewhere.

Jamie Hepburn: I have a quick final question on getting the appropriate powers to the appropriate level. I do not think that I am mischaracterising Ben Thomson and his organisation when I say that it is clear from the work of Reform Scotland and from what he has said today that they are great supporters of further and substantial devolution of powers to Scotland. You seem to have ideas about how such powers could be further devolved to a more localised level. Do you accept that there is absolutely no guarantee that there will be further devolution in the event of a no vote?

Ben Thomson: There are no guarantees of anything in life; I wish that there were. As you know, we have been campaigning for the past five years for substantially greater devolution because we think that decentralisation is a good thing. We set up devo plus to try to convince the three unionist parties that it would be sensible to have greater devolved powers. We suggested a Glasgow agreement, to try to bring those parties together in a consensus. I am delighted to say that, yesterday, the Conservatives made a relatively good step by going as far as the Liberal Democrats have done by pushing down more fiscal powers and some elements of welfare. That is a step in the right direction.

I do not think that there are any promises, but I am delighted that, if we get a no vote, it will be hard not to see some real and substantial changes happening. Obviously we will be pushing for a lot more than is being offered, but it certainly looks as though it will be hard to reverse after a no vote.

Jamie Hepburn: You say that

“it will be hard to reverse”,

but the bottom line is that there is no Glasgow agreement, there is no coherent programme, and there are no guarantees whatsoever, are there?

Ben Thomson: I still work my hardest at that, as we all do.

Jamie Hepburn: There is, however, no guarantee, is there?

Ben Thomson: I am just saying; it is a matter of fact that I work my hardest at it, but there is nothing yet, and there are no guarantees in life.

Michael McMahon: I will not ask any of the panel to guarantee the growth rate that Scotland would have if it were independent. However, the growth rate is important to a lot of what is being discussed in terms of how we move forward.

I specifically want to consider welfare spending. The IFS document might have been added to this morning, because the welfare expert group has produced its report. The figure that Martyn Evans gave this morning for the additional benefits bill if the issues that are to be addressed are taken forward was, I think, £280 million. The Scottish Government has said that all of that will be found from additional growth. It does not want to increase taxation and it wants to cut certain taxes but it also wants to increase welfare spending. How credible does each member of the panel feel that those desirable—no one is disputing that they are desirable—improvements in welfare spending are, if we cannot guarantee the growth rates that the Scottish Government says that it needs in order to achieve that outcome without increasing taxes?

Ben Thomson: Who are you looking at?

Michael McMahon: We could start with Gemma Tetlow, given that I quoted the IFS.

Gemma Tetlow: There are a few issues in your question. The first thing to say is that, at the point of independence in 2016-17—assuming that the negotiations take about 18 months—our estimate, using the OBR’s latest projections for the UK’s public finances, is that an independent Scotland would have a deficit of about 5.5 per cent of GDP. That level of deficit would not be sustainable for any significant period—it would not be sustainable for the UK as a whole, and it is unlikely to be sustainable for an independent Scotland, which would be a small country with no record of borrowing from international markets. Therefore, if that turned out to be the case, we would probably be in the situation of having to either find further spending cuts or make tax increases at the point of independence. If that were the case, the package of measures that is set out in the white paper, plus the £280 million that you are talking about, would amount to a net fiscal giveaway, at least in the short term, and things like higher growth would take some time to feed through and produce benefits for public finances.

That is the background against which we need to think about any pledges that are made on spending commitments or tax changes after independence. However, two points must be made in that regard.

First, the tendency to focus on giveaways is not exclusive to Scottish independence. We are seeing very much the same thing among the main political parties in Westminster as we approach next year's election—there is much more discussion of giveaways than takeaways. That is just a fact of political life.

The other point concerns the fact that the issue of exactly how quickly any fiscal tightening might be needed in an independent Scotland is sensitive to two particular factors. One is the decision that is made on the allocation of debt between Scotland and the rest of the UK. In the papers that we published today, we show the sensitivity between a population share of debt and zero debt. Even with zero debt, we estimate that Scotland would be running a primary deficit in the first year of independence—in other words, just to cover spending on other areas, Scotland would need to issue further debt.

The other great sensitivity is to the level of revenues from North Sea oil and gas. The 5.5 per cent deficit is on the basis of the OBR's projections. Obviously, the Scottish Government has set out a range of other scenarios using industry projections, particularly for production, and some alternative price scenarios. If revenues from oil and gas were substantially higher than the OBR suggests, that would ease the pressure for immediate spending cuts and tax increases, because the fiscal position would be much stronger. However, if we look further forward, as the Treasury paper did last week and as some of our own analysis did at the end of last year, the pressures that start to build up are threefold.

12:00

First, there is demographic change. The populations of the UK and Scotland are ageing, which tends to put pressure on pensions and healthcare spending in particular. That is a pressure that is faced by the UK and would be faced by an independent Scotland.

More important for an independent Scotland than for the UK as a whole, I presume that reserves of oil and gas in the North Sea will start to deplete over the longer term and that that source of revenue will start to decline—exactly when and how quickly that happens remains to be seen. That would be a much greater challenge for an independent Scotland than it would be for the UK as a whole. Oil and gas revenues are a relatively small part of revenues to the UK Exchequer but would represent a very large share of revenues to a Scottish Exchequer.

Currently, the higher level of per capita spending in Scotland is being just about paid for by that higher level of oil revenues, if they are allocated on a geographic basis. As we look to the horizon a decade or more hence, that will not be the case and a Government of an independent Scotland, like a Government of the UK, will need to make decisions about how to reduce the fiscal deficit by finding savings on spending or by increasing taxation.

Ben Thomson: On the question of increases in GDP, I will be frank and say that I do not think that politicians can influence GDP particularly directly and make promises about what will happen—I have not yet met one who has done so accurately. GDP can go up and down.

However, in general I am a born optimist. Five of Scotland's top industries when I came up to live here 30 years ago are no longer there, but we have found ways to replace them and we have still managed to grow the economy. We can always talk about things going wrong, but we have an educated workforce, which will create an economy that will grow over time in a certain way. I am optimistic that we will continue to see growth in the Scottish economy, because we have a people who will go out there and keep pushing to grow businesses and develop technologies.

We can all talk about what we might or might not lose in GDP, but we will find ways to replace losses over time. There might be times when we have difficulties and times when we do not have difficulties, but I am a great believer in our ability to continue to grow the economy over time.

My personal view is that we spend far too much time looking at inputs and perhaps even outputs, rather than outcomes. Mr McMahon's main question was about how we address the welfare issue. I think that we need a real change of culture. It is not about spending an extra £100 million here and £50 million there or about cutting taxes; it is about making local communities and people feel engaged and responsible for having a community that works.

That takes me back to the point—I do not particularly want to reiterate it—about giving local government and local communities the encouragement, the tools and the confidence to go out and find the way in which they want to address welfare. That starts from community level and right from the word go, so we need to focus on how communities can start to develop the youngest children, at nursery school and even pre-nursery school, and then continue that work all the way through the education system and beyond.

We can talk for ever about a few tax cuts here and a bit more welfare there, but unless we can get that change of culture, we will never address the real problems that we have for the bottom 10 per cent of society, and that has not really changed over the past 15 years. Indeed, there is now a widening differential between the haves and have-nots, an example of which is in attainment levels at school. Over the past 15 years, the attainment of people who get free school meals has been getting worse relative to that of the remaining 90 per cent. That demonstrates that our current approach is not working.

If our approach is not working, why cannot we get a real change of culture that changes outcomes, and stop worrying so much about whether tax levels should be a tiny bit higher or lower, which simply will not fix the problem?

Michael McMahon: That is a fair point.

Professor Hughes Hallett: I made a rapid calculation, which is probably not exactly right. You mentioned £280 million—

Michael McMahon: That is the figure that Martyn Evans gave.

Professor Hughes Hallett: That would require 0.15 per cent on the growth rate for a year, which is tiny.

Michael McMahon: It is tiny in relation to what was announced this morning, but the IFS has looked at other figures and has produced calculations that showed that

> "in 2018-19, rather than being 0.8% lower per working age person, benefit spending in Scotland would be 1.4% higher".

You are talking about quite a small increase but the deficit would increase. The point that I was making was that the Scottish Government has said that it will increase public spending based on the First Minister's guarantee that there would be growth levels in excess of what you said you found the OBR's predictions to be now. That is essentially my question. The Scottish Government makes commitments in its white paper on increasing public spending based on an increase in the growth rate.

Professor Hughes Hallett: That refers to a wider portfolio of things that it might do. I am not going to question any of that; I was just saying that that particular thing is probably fairly easy.

I agree with Ben Thomson—this is a facetious remark—that politicians do not usually increase the growth rate. We have had that argument and I pointed out that the growth rate increased as soon as the Council of Economic Advisers was appointed. It can be done, but not necessarily by them.

I have a problem with the deficit figures, because they are based on projecting forward the economy as it is now—the status quo with the rules of the game that apply now—and that does not necessarily reflect what would happen if Scotland were independent or if there were a great deal more devolution.

To capture the argument at the end of the previous question, decentralisation is generally helpful. As Ben Thomson says, you want to decentralise as much as you can. Where you stop is a matter of judgment. You stop when there are diseconomies of small scale, because at some point it becomes inefficient to decentralise any more. The point at which that becomes the case is more difficult to calculate.

If the demographic changes happen as projected, there is a problem. I find those figures distinctly unsafe further out, but that is another argument.

Oil revenues may, indeed, be smaller and they will run out eventually—something will run out—so there is an argument for diversifying away from dependence on oil, which you would imagine would be a sensible general strategic policy to follow. However, the problem is that you cannot do that unless there is some decentralisation. How would you create the circumstances in which that can happen? If the oil is running out, the firms will look to do something different, but if you want to kick-start that process through a policy, you cannot do it without some decentralisation.

Michael McMahon: I have another point that could be answered fairly quickly. I again come back to the IFS calculations based on the white paper. My question is about the childcare commitment. The IFS has seriously questioned the validity of the assertions made by the Scottish Government about childcare. Does the IFS want to take the opportunity to explain why it questions their validity? We have asked the Scottish Government for its modelling but that has not been forthcoming. The IFS must have done some form of modelling. If it could explain to us why it has such difficulty with the white paper's prediction, that would be important.

Gemma Tetlow: I will start by making a general point. Despite the fact that both the Scottish Government and many of the main parties in Westminster seem to be very keen on further subsidies for childcare, the evidence that general subsidies for childcare produce benefits in terms of increased female labour force participation or child outcomes is surprisingly limited.

When we surveyed this in "The IFS Green Budget" earlier in the year, we found that there is relatively little robust evidence that such policies pay for themselves or have a significant effect. There is evidence that targeted policies for disadvantaged children have positive benefits, but it is not clear that any of the parties, either in Westminster or in Holyrood, are talking about those kinds of things.

On the specific figures that were in the Scottish Government's analysis of the potential impact of its childcare policies, I believe that it has stated that the scenarios that it set out for increases in employment rates, given implementation of the policies, were not an attempt to model what effect the policies might have but were simply indicative scenarios to say, "If you get this kind of response, this is how much the policy will pay for itself."

Michael McMahon: Do you mean that it was not a guarantee?

Gemma Tetlow: I certainly do not think that it was a guarantee. Our analysis suggests that the higher of those two indicative scenarios implies really strong responses to the policies in terms of employment rates. In particular, the top two estimates of the three imply not only that every single non-working mother who is directly affected by the policy is entering work but that a number of other women who are not directly affected by the childcare subsidy are also moving into work as a result of the policy reform. I am not sure how helpful it is to the public debate to demonstrate such optimistic scenarios for the kind of response.

Michael McMahon: Does anyone else have any comments on that?

If not, I particularly wanted to get the IFS's view, so that is helpful. Thank you, convener.

The Convener: Thank you, Michael. Malcolm Chisholm is next, to be followed by Jean Urquhart.

Malcolm Chisholm: I just want to go back to the initial quote that the convener used, because it is fairly fundamental to Andrew Hughes Hallett's paper, in which he says:

> "Nothing would change for Scottish monetary policy if London were to refuse to share sterling ... Scotland ... would ... be unambiguously better off."

You went on to say in evidence, Professor Hughes Hallett, that there would be a disadvantage in relation to the liquidity provision of the banks, for which your solution would be opting in to the EU's regulatory and banking union, as Denmark has done. However, Denmark is in ERM II, with its currency pegged to the euro. Surely Scotland would not be in that position.

Professor Hughes Hallett: Denmark is not in ERM II; it just has its currency pegged. However, it is open—I checked this with the legal people in Brussels—to any EU member to opt in. Denmark does not have the currency. The guarantee on the currency is from the ECB.

Malcolm Chisholm: You went on to say in your paper that in the event of Scottish independence

> "some banks or financial firms may feel safer and better catered for if they move"

into Scotland. That is the opposite of what many of your colleagues are saying. If what you suggest is the case, why are banks and financial firms not going to Frankfurt now?

Professor Hughes Hallett: That is a good question. Perhaps it is because the restaurants are not quite so good.

Malcolm Chisholm: In terms of there being no advantages in the status quo, you—

Professor Hughes Hallett: The answer to your question is that they do, but not from Britain particularly, because they go to London.

Malcolm Chisholm: I know, but we are talking about—

Professor Hughes Hallett: They are going to London, not to Frankfurt.

Malcolm Chisholm: But we are talking about what you say in your paper about the rest of the UK. You say that there are no advantages in the status quo, but surely if Scotland had been independent at the time of the financial crash and using sterling outside a currency union we would have been in the same position as Ireland as far as the banks were concerned.

Professor Hughes Hallett: Yes, and that is what happened. Being in the union is what happened.

Malcolm Chisholm: So we did have a big advantage from being part of the United Kingdom at that time.

Professor Hughes Hallett: No. I am not saying that there are no advantages in being in the UK banking union, but the banking union did not help the banks during the financial crash; that had to be done through nationalisation. The same propositions are available in the EU banking union. They may or may not decide to use them, but the opportunity is there. The only difference is that the EU's resources are rather larger.

Malcolm Chisholm: Yes, but the question is whether we could get into that. The main disagreement between your paper and Gemma Tetlow's submission is in relation to the situation that would face us in the immediate aftermath of independence, rather than in the distant future. In your paper you refer to a whole list of things, such as

"the return of subsidies currently made to rUK pensions, the return or part return of debt interest payments currently made to the UK Treasury".

I do not know whether that means ones that have already been made; if so, that would be rather astonishing. You end your list by saying that there would be "a small budgetary surplus". I have to say that your view is contrary to all the evidence that we have heard, as far as I am aware.

The Institute of Fiscal Studies obviously has a radically different view from Professor Hughes Hallett. In fact, in two independence debates I have quoted the paper by Gemma Tetlow and her colleague Rowena Crawford, which states that Scotland faces "a tougher fiscal challenge" and that that

"is robust to a variety of alternative, sensible assumptions."

I would not like Gemma Tetlow to be unpleasant to Professor Hughes Hallett, any more than I want to be, but do you think that some of the assumptions that he makes are sensible?

Gemma Tetlow: I have to say that I read Professor Hughes Hallett's evidence and I am afraid that I do not follow his arguments around changes to pension flows and other spending flows. I would very much welcome greater clarity from him about exactly what he means.

The point that Mr Chisholm quoted from our previous paper about tougher fiscal challenges for Scotland was made in the context of thinking about the next few decades, rather than the next five years. Our central point in that paper was that, obviously, there are considerable amounts of uncertainty about what is going to happen over the next 50 years, so I would not pretend that the kind of projections that we or others are making are going to turn out to be correct. However, our broad conclusion that the fiscal challenges for Scotland look to be tougher than those facing the UK as a whole was robust to a range of different assumptions around some of the key factors that have been raised in the debate here, especially around growth rates of productivity, inward migration into Scotland and the level of debt that an independent Scotland might start with. Even allowing for a range of possible assumptions around those things, we came to a broadly similar conclusion, although the exact magnitude of the differences is very sensitive to those assumptions.

12:15

Malcolm Chisholm: Do you wish to comment on the assumptions that you have made, Professor Hughes Hallett?

Professor Hughes Hallett: Sure. The list of things is okay; it is the numbers that matter. If we have different numbers, we will come to different conclusions. It is a question of where we get the numbers from. As I explained during the previous agenda item, the figures are back-of-the-envelope numbers—not mine, in any case, but other people's. Other people are saying the same thing.

It depends what we assume. One assumption is the amount of debt interest payments that you have to make. It depends on how much debt is inherited or taken on from the UK after separation. If we assume that a deal is done in which all the debt is taken on, the debt interest payments will go down slightly, because the amount of debt that Scotland would take is slightly less as a percentage of Scottish GDP than the UK amount. It would be slightly smaller, but not so as to make a big difference. That will change the numbers in the calculations that I used. On the other hand, Scotland might take no debt, in which case there will very much be an improvement on the deficit. It depends what comes out of the negotiations.

I have taken the middle option, on the historical debt ratio figure, roughly speaking. And so it goes on with the various things—it depends what you think the oil revenues would be in the next five years. I have not used the Scottish Government numbers and I have not used the OBR numbers. The OBR has the revenues going down; the Scottish Government has them going up; I am somewhere in the middle, with a slight improvement over the last year's number.

I am illustrating the unrobustness of the statement that Scotland will have a deficit of such-and-such a size.

Malcolm Chisholm: I will come back to debt in a minute, but I will first ask Ben Thomson something. The first thing on your list is

"the return of subsidies currently made to rUK pensions,"

which I do not recognise. However, I know that you have a particular interest in pensions, particularly with reference to your scheme for devo plus. You think that there are advantages to state pensions remaining at the UK level. Could you give us your thinking on that, and could you relate it to that strange statement about

"subsidies currently made to rUK pensions"?

Ben Thomson: We view pensions as a somewhat separate issue. We have just done a paper on pensions, which points out that the real problem with pensions in the UK is that they are, by and large, unfunded in the public sector. In other words, we are not creating and building up a fund to pay pensions. The national insurance that we pay goes to pay current pensioners, rather than creating what was originally intended, which was a pensions pot. That means that no politician can really give any certainty about how much pension people are likely to receive or when they are likely to receive it. For most of us, the decision will be determined by people who may not even have been born yet. They cannot say whether we are going to retire at 70, 75 or 80. That is an unsatisfactory position to be in.

The expenditure on public sector and state pensions in Scotland is about £15 billion, split roughly 50:50 between the two. The pension population will grow by just over 25 per cent between now and 2025. That is not a sustainable position to be in, particularly on top of the deficit that we already have.

I come back to the point that we need to do something completely different. We cannot just fiddle around at the edges. The UK pensions minister recognises that, I think. Whether we are an independent Scotland or part of the union, we have to address what has become a serious problem: how, as an outcome, to look after people when they reach old age.

Our paper proposes a long-term model such as the one that has now been adopted in Australia, where people have to contribute to a mandatory pot over their lifetime, whether they are in the public sector or the private sector. That builds up from about 8 per cent, and eventually it will have to go up towards 15 per cent of people's salaries. That is a way for people to have their own assets, which they can look after as they want to into their old age. It is an attempt to create a change of culture.

On your specific point about whether pensions should lie at a UK level or a Scottish level, we think that at the moment it is probably simpler for them to be at the UK level, because they are there and there is standardisation, and there would be a huge amount of chaos if they changed. Theoretically, there is nothing wrong with Scotland—or for that matter, the whole of the European Union—creating a pensions pot. It is probably simpler and more straightforward to have it at a UK level, but there is no theoretical reason why it cannot be at any other level of Government. Our aim, over time, is to eliminate most of the pensions that are controlled by the public sector, so that they become personal pots that people look after. All that the public sector would then be looking after would be how to alleviate poverty in old age, which is clearly the responsibility of Government.

Malcolm Chisholm: With my last question, I return to the issue of debt, which is fundamental to what Scotland's fiscal position would be in 2016. I thank Gemma Tetlow for giving us a long-term view, but I would like to know about her assessment of the 2016 fiscal situation. Andrew Hughes Hallett seems to be implying that we could voluntarily assume some debt but that it is not required. My question is, why do you think that we do not have an obligation to take our share of debt, and, if we did voluntarily decide not to have anything to do with the debt, would that not have a punitive effect on interest rates for future Scottish borrowing? Jefferies investment bank said a week or two ago that there would be a five percentage point premium if that was the case; you may not agree with the five points, but I think that there would be some premium. For many people in Scotland, that is the key question, because people wonder what things will be like in the immediate aftermath of independence, and it seems to me that it is critical that we get a view on that. We will not get agreement, because there is a massive divergence on the panel, but we should try to find out what the consensus view is.

Professor Hughes Hallett: I do not know that there is that much disagreement on the panel. We have not had our post-coffee discussion yet. On why it would be voluntary, the answer is that it is because the UK has acknowledged that it has legal title. From then on in, it is a negotiation. That is why it is voluntary; you set your red lines on the negotiation where you want to set them. You could say, "These negotiations are not favourable and we're not going to take any debt at all."

After independence, there will be an initial period during which interest rates will have some kind of premium. I do not know about 5 per cent; what I usually hear from the city is a figure of between 0.5 and 1.5 per cent.

Malcolm Chisholm: That is what the figure would be anyway. What Jefferies was quoting for was what would happen if we walked away from the debt. That is when you would get the big premium.

Professor Hughes Hallett: Certain countries periodically walk away from their debts. What you see from that is that there is a spike in the interest rates afterwards and that very soon they are back in the markets. Ireland did not walk away from its debt, but it was in receivership for some time. When it went back to the markets, it took only two months to get an interest rate for issuing new debt that was lower than Sweden's, the best performing economy in the EU.

I do not want to make a prediction about what will happen. There would be some risk premium on the interest rates—after independence, there will be anyway—but I would not reckon on its being particularly high or staying there for very long. In fact, I have an argument with the papers that calculate those things because they use the wrong variables to calculate them. However, that is not the main driving force. The mechanics of who has ultimate responsibility for that debt is understood. The reason for that UK statement was that people wanted to quiet the markets down. It will get paid for, and then the risk premium will not be because you walked away from the debt but because the Scottish Government will be untried as an institution issuing debt. Once it has smoothed in, my guess is that the risk premium would get smaller.

Malcolm Chisholm: My 15 minutes are almost up, but I wonder whether Gemma Tetlow will comment on the 2016 comparison between Scotland and RUK. I saw that Ben Thomson put his hand up, so perhaps he, too, might want to comment on the matter. However, I do not want to overstay my welcome.

Gemma Tetlow: With regard to the position in 2016-17, I point out that, in an attempt to allocate onshore revenues, the numbers in GERS and those from the HMRC indicate broadly similar levels of onshore revenue raising per person in Scotland and the rest of the UK. There is broad agreement on that, and I think that there is reasonably broad agreement on the allocation of public spending between Scotland and the rest of the UK in an attempt to come up with a number for the Scottish fiscal balance. Those two numbers underlie our estimates for the fiscal balance in 2016-17.

However, there are two areas where there is less consensus on a correct estimate for Scotland's fiscal balance in 2016-17. First, there is uncertainty around the level of debt interest payments that an independent Scotland would have to meet. Professor Hughes Hallett has already mentioned that, and clearly it would be a matter for negotiation. Secondly, there is uncertainty about and some disagreement on the revenues that would be raised from offshore production. The 5.5 per cent that we have suggested assumes a population share of debt and that the OBR's forecast for oil revenues is correct. If Scotland took a smaller share of debt and/or oil revenues were stronger that year, Scotland's fiscal deficit would be smaller.

Ben Thomson: One would assume—indeed, hope—that, in the event of a yes vote, a constructive, positive and co-operative set of agreements would emerge over the following 18 months up to independence. If we do not assume that the negotiations will be constructive, it is hard to suggest what will happen.

One has to accept that, if there is to be a constructive set of negotiations, Scotland will, morally, have to stand up and take its percentage share of the debt, and a structure will have to be devised on the basis that even with those obligations Scotland will be solvent and will not default. After all, it is neither in the rest of the UK's interests nor in Scotland's interests to have defaulted obligations from day 1, as that will simply increase costs. One has to assume that the negotiations will be undertaken in a rational and positive way.

You are absolutely right that there will be greater uncertainty around a smaller country, particularly a new one. That will give rise to certain costs; indeed, there will also be set-up costs to meet, but those are some of the downsides of voting for independence. Of course, that should be balanced with some of the positives, and I certainly think that there are positives as well as negatives to consider.

As I understand it, the basis of your argument is that, if Scotland has a high level of debt that it subsequently defaults on or if it does not honour its obligations, interest rates will be high. I see that happening only in the short term if the negotiations between the UK Government and Scotland turn out to be unconstructive and unpositive. I would like to believe that after a yes or no vote politicians will accept the will of the people and get on and do a good job for the public to ensure that that does not happen.

Jean Urquhart (Highlands and Islands) (Ind): I want to go back to the Reform Scotland submission and Mr Thomson's earlier comments about decentralisation. When you take such a position, where do you stop? I fundamentally agree that when people are responsible for raising taxes and spending those revenues, they might have a different view about how money is spent, how things are maintained and so on. What reserved matters do you think should be left reserved? What should we not be responsible for?

Ben Thomson: As far as this issue is concerned, we have tended to look through the wrong end of the telescope and think about the powers that should be passed down. The basis that I and Reform Scotland start from is that as many powers as possible should be as close as possible to where the public service is provided, and only if it makes sense for those powers to be exercised by a higher level of government—if, for example, that just works better—should they be pushed up.

There are obvious areas that I believe should be pushed up. Those include regulation of the banks, monetary policy, defence, foreign affairs and environmental controls, which do not work in a global world if they are dealt with at a very local level.

12:30

I will draw an analogy at this point, if I may. Looking back 20 years ago, before the internet, people were quite happy to use centralised systems. We all made our travel bookings using travel agents, for example—I am sure that Holyrood would have had one. Now, as a result of the world wide web, we have a global language that is controlled globally and allows us all to speak, but at the same time we perform most functions very locally, and book our travel ourselves.

Applying the same analogy to the public sector, we can see that certain things become more and more global. We cannot control corporation tax in the local area because businesses are now global, so that has to move to a more global basis. We cannot control banking, which is increasingly becoming more international and global, at a local level; that must be done globally. We cannot control the environment or implement fishing controls at a local level, because if we do it and someone else does not, it does not work. Those things have to move globally. We cannot create a safe defence in a very small unit—it makes sense for that to become global.

That is happening not only at a Westminster level. NATO, the European Union and the United Nations are constantly evolving and adapting to cope with some of those global issues.

I come back to what I said at the Economy, Energy and Tourism Committee a few weeks ago. I am chairman of a small business that publishes books for dyslexic children. Ten years ago, we were completely Scottish: everything that we did was Scottish, the business was all based in Scotland and our sales were in the UK. Now, all our books are published in China, we have a website in five different languages and we distribute books throughout the world. Even little businesses with very small amounts of revenue are now becoming global businesses.

As a public sector and as politicians, you need to address the fact that the world is changing. We are moving to a world in which certain things are very globalised and need a level of global co-operation. Those are the areas that should increasingly be addressed at higher levels of government.

We have the ability to do a lot of things ourselves, because we have that global infrastructure, on local issues. As a general philosophy, we should be given the tools at a local level to deal with local issues and local services. Other things, which are global, should move to a more global level.

Jean Urquhart: Mr Thomson, I have to say that I could not disagree with you more on quite a lot of your statement. Are we going to be borders free? Will there be one world order? Where does it stop?

You talk about leaving spending or policy decisions on certain issues to a bigger Government. I am not quite sure what size or area the bigger Government that you mention would cover. Would it be Europe-wide? Would your defence policy include America? How would that work? Surely those decisions would ultimately affect your control of local decision making in respect of other policy areas, such as welfare, house building or the general wellbeing of the population.

Ben Thomson: We are becoming more borders free, quite frankly. Trade has increased by eight times since—

Jean Urquhart: I am going to interrupt you. Of the small countries that are the same size as Scotland, none is asking for its borders to be taken away so that it can have a joint policy with other nations. Such countries may have joint policies with other nations, but they maintain their independence as nation states. Do you agree?

Ben Thomson: Yes, but—

Jean Urquhart: They can work with other countries without actually sharing policy.

Ben Thomson: Are you putting words into my mouth, or do you want me to—

Jean Urquhart: I am just suggesting, as you are, that globalisation—

The Convener: He wants to answer you, Jean.

Ben Thomson: You have to accept that the concept of nations is starting to change. The next generation does not have a really strong affiliation with nationhood in the way that we do, just as we find slightly ridiculous the idea of empire that our grandparents may have had. The next generation is far more used to European concepts, such as supporting and watching football teams around Europe or supporting the European team in the Ryder cup; it looks at things globally. The idea that we are stuck between borders where nothing happens is very antiquated.

If you look at the way that commerce is working, you will see that trade is happening far more freely. I come back to the point that I was making when I was interrupted: global trade has gone up by eight times, although GDP has only gone up by 100 per cent, since 1985. That has happened because there has been a huge opening up of borders across the world. You say that borders are as closed as they were, but, looking at the statistics and the analysis, I do not think that that is right.

Jean Urquhart: I did not say that they were closed; I meant that there are still nation states that are not arguing not to be nation states. Ireland does not see an advantage in being part of the United Kingdom again: it is not making that case on the basis of commerce, trade, globalisation or any of the points that you raised.

I would like to move on to the point that you make about demographics—this question is probably for the witness from the IFS, as well. To my knowledge, no population forecast or prediction has been correct. Do you agree?

Gemma Tetlow: I am no expert on demographic forecasting and I cannot comment on past projections, but any projections over the next several decades are likely to be proven wrong. That said, we know that the demographic structure of the UK population has a bulge of people who were born in the immediate post-war period and who are now transitioning out of the labour force into retirement, but that bulge is not being matched by another explosion in the working-age population.

What largely underlies the demographic challenge is that a greater share of our population is now aged over 65 than is aged under 65, coupled with the fact that people are living longer and longer. However, that hides some of the opportunities and challenges. There is a tendency to think of 65 as a cut-off point between working and retirement, but we are seeing strong trends of rising employment rates among older people, because of active Government policies and other trends. Perhaps we do not need to be so negative about the challenge.

It is more a case of people's economic dependency, which is not particularly age based and is affected by a number of other factors.

Jean Urquhart: How do you account for the dramatic difference between the population growth rate in the rest of the UK and the very small population increase in Scotland?

Gemma Tetlow: None of our work is based on our own demographic projections. We used the official estimates of the Office for National Statistics. In particular, for the UK, we focused on the low migration scenario, which the OBR argues is most in line with current UK Government policy on limiting inward migration. I would not like to comment on the specific differences in the ONS projections.

Professor Hughes Hallett: I was asked earlier whether I had a high opinion of the OBR's forecasting. This is a case in point. You will see from my submission that the difference is not easily explained. Why the OBR forecasts a scenario in which the RUK population grows six times faster than Scotland's is something else that is not easily explained. I do not disagree that the RUK population is growing faster, but I am not sure that it is growing six times faster. One could do as I did and ask questions about that. I put in some eye-catching numbers on that issue in my submission—at least, I hope that they are eye catching.

On the specifics of how the situation might be happening, you can see from the table in my submission that there is a big fall in the working-age population—as Gemma Tetlow said—and a rise in the number of people aged 65-plus. For the purposes of full disclosure, I will say that I have a certain interest in that. However, the 65-plus cohort is passing through; it will go away. This is not something that will last; it is a particular event.

Of course, the situation could be down to differences relating to immigration. Immigration in general is difficult to talk about nowadays, but it is not clear why immigration to Scotland should be so very much lower, especially as current information says that the percentages are rather similar. Why, suddenly, is there no immigration to Scotland? I do not know.

Equally, the situation could be down to a lot of immigration in the 65-upwards bracket—we might call that the Florida syndrome, because that is what happens in Florida. In that case, we would have to put into the calculation the fact that those people bring money with them—they do not come here and die from starvation.

The calculations are highly unsafe.

Gemma Tetlow: Clearly, there are different projections for the population size and structure under alternative assumptions, particularly around inward migration. I would like to clarify something that was in Professor Hughes Hallett's evidence about the longer-run projections for the fiscal positions of Scotland and the UK. It is not the case that all the messages around those long-running projections are based solely on an assumption around the low-migration scenario from the ONS. As we showed in our report at the end of last year, many of the main messages remain, even if we assume the ONS high-migration scenario of net inward migration to Scotland of 25,000 a year, compared with 9,000 a year in a low-migration scenario.

Assuming much higher migration changes things a bit but does not fundamentally change many of the messages that come out of such longer-run projections.

Jean Urquhart: Do you agree that a country that was in charge of its own immigration policy could target particular people to come and live in it, as previous Scottish Administrations did?

Gemma Tetlow: I certainly would not want to suggest that there would not be benefits to Scotland having greater control and being able to operate different policies from those that are currently operated in the UK.

Jean Urquhart: It could have a different effect on the financial outturn of the nation's wealth.

Gemma Tetlow: It certainly could. However, without specific details—well, even with specific details—it is hard to know how that would play out over several decades.

Jean Urquhart: Are all the figures that we are presented with based on the status quo and Scotland remaining in the United Kingdom? Those of us who believe that independence for Scotland is the right thing would seek to do quite a lot of things differently. That is the ambition. You have said that many of the figures either come from somewhere else or have to be qualified, but there is a different scenario that could be much more positive than the one that appears in your paper.

Gemma Tetlow: Perhaps I can try to clarify the models that we have set out in the past and the models that the OBR constructs in its fiscal sustainability report, and what they do, because they certainly have limitations. In essence, they build from an assumption that the tax take per person of a particular age and sex, as well as the spend on different items such as health, pensions and education per person of a given age and sex, stay at the same level going forward, often growing in line with the growth in average earnings in the economy. That is broadly how those models work.

In that context, you can try to characterise alternative policy frameworks by varying assumptions. For example, you could vary assumptions about productivity growth if you thought that a more efficient tax regime could boost productivity in the country, or you could vary migration assumptions if you thought that alternative policies on migration might change the population structure. To that extent, it is not fair to characterise all the projections as being based on unchanged policy. It is possible to build in alternative assumptions about economic growth and population size that might reflect some of the alternative policies, although how exactly those different outcomes would be generated is not entirely built into the model. To that extent, the models can try to capture alternative policy scenarios.

If you think that higher productivity growth and higher earnings growth in Scotland would be the outcome of policies under independence, one key question about how that would feed through into the fiscal balance is whether public spending would also grow in line with the growth in the economy.

If you assume that you can hold down public sector growth while the economy is growing significantly—essentially, that is the assumption that is made in the scenarios that were presented in last week's Scottish Government paper—the implication is that the state is shrinking as a share of GDP, so you end up in a stronger fiscal position because you spend less of GDP on health, education and benefits.

12:45

My only caution around that is that we have never seen such a scenario in the UK. We have had periods of robust economic growth, which have often led to pressure to increase public spending in line with the growth in the economy. If the economy is bigger and the same share of the GDP is going on public spending, your population will get better public services and a better level of benefits. That would be a better outcome for the population, but it does not necessarily feed through into a stronger fiscal position unless you choose to constrain public spending at the same time.

Ben Thomson: I welcome what Jean Urquhart says. If looked at from a decentralisation perspective, difference is a good thing. If you push down powers, people will do things differently, which will produce different results. We have encouraged much more devolution of powers not only to the Holyrood level, which I know that Jean Urquhart would support, but to the local level. The centralisation of policing was a hugely retrograde step, for example, because, as has been pointed out, policing in one area can be done entirely differently from policing in another area.

Decentralisation leads to greater divergence and more ways of doing things; we can learn from others about how things get done. I totally agree with Jean Urquhart's point.

The Convener: Of course, you would have fewer police officers to deliver the service.

Gavin Brown has a question.

Gavin Brown: My question is for Mr Thomson. You gave a very clear picture of what you want to see happen to taxation, with all taxes devolved except national insurance and VAT. Let us assume for a moment that you are successful and that you win your argument. What taxation would you then devolve to local government? Would you go a step further and devolve some taxation powers from local government to, say, community councils?

Ben Thomson: First of all, let me be clear: there is a huge difference between powers and what you do with them. There is a separate argument that goes beyond what happens with powers—there is a debate about what you do with them.

We would remove the council tax freeze and allow councils to spend what they want to spend, give them back the business rates and allow them to look at other ways of raising income, including through other taxes. Council tax and business rates raise around £6 billion, which is still a very small part of local government expenditure, depending on whether health is included in local government. We want to see at least the majority of local government expenditure covered by taxes that are raised by local government.

I have just seen a very good chart—I can send it to you—of all the different ways in which state tax is raised in the United States. It is interesting to see the varied ways in which different states use their taxation powers to create an environment that works best for their state. There is no race to the bottom. We all recognise that we have to raise taxes to provide public services, but states such as Washington raise their income almost entirely through sales tax and have very low income tax, whereas other states raise 50 per cent of their income through a local income tax. That creates a real sense of diversity, as Jean Urquhart mentioned, and a choice of systems, which is a good thing.

Gavin Brown: My next question is for Gemma Tetlow. The IFS modelled the fiscal position of Scotland over a 50-year period, with various scenarios in relation to immigration, productivity growth and so on. What assumptions did you make in that modelling for the percentage of annual increase in public spending?

Gemma Tetlow: Up to the end of the medium-term forecast horizon, which at the time we were publishing our report was 2017, we essentially assumed that an independent Scotland would follow the same fiscal squeeze that was pencilled in by the UK Government. That implied freezing total spending and cutting public service spending over the further two years beyond the point of independence in April 2016.

Beyond that horizon, as I just explained, our modelling essentially assumes that each area of public spending per person of a given age and sex grows, in most cases, in line with average earnings growth in the economy, so there would be positive real-terms growth in most areas of spending. The extent to which that aggregates up to a total level of spending for the economy depends on how the number of people in each age group varies. For example, education spending would tend to grow less quickly in our model because the number of kids is low.

Gavin Brown: The reason I asked was because the Scottish Government paper that was published last week expressed a preference for a 3 per cent increase in public spending and said that the current UK increase was 1 per cent. If you fed in a 3 per cent increase instead of the current UK spending projections, what impact would that have on the size of the deficit?

Gemma Tetlow: With regard to the paper that we published today, if we assume that spending grows roughly in line with GDP growth for the three years from 2016 to 2018 rather than continuing with the fiscal squeeze that is pencilled in by the UK Government, that will give a 2.5 per cent annual growth, which is a little lower than the 3 per cent that the Scottish Government has suggested. In those circumstances, our estimate is that the fiscal deficit of Scotland would stabilise at around the 5.5 per cent of GDP figure that we talked about earlier. If the deficit in 2016-17 was somewhat lower than that 5.5 per cent, it would still be the case that a real-terms growth in public spending would mean that you would stabilise your deficit rather than cutting it further, which is what is pencilled into the UK Government's plans.

Gavin Brown: My next question is for Professor Hughes Hallett. In your submission, you say:

> "It would be reasonable to expect North Sea revenues to rise to £4.5-5bn between 2016/20 on the basis of the industry's own forecasts".

Could you explain how you concluded that it would go to £4.5 billion to £5 billion over that time?

Professor Hughes Hallett: The particular number comes from the change in speculative revenues according to Oil & Gas UK. The reason why you would expect the revenues to increase—as I say in the sentences in the submission before the one that you read out—is that there are reasons why they have been depressed. One is that demand has been down during the worldwide depression, and you would expect that that would increase after a time. Another is because of the surcharge tax, which has now been lifted—there was less incentive for firms to produce when there was higher tax in place. As such constraints come off, you would expect the output to rise.

It is also reasonable to suppose that the industry expects the output to rise and the revenues—industry's revenues, not necessarily the tax revenues—to rise because it has been investing a lot. Industry does not invest for no reason.

Other reasons involve the fact that some of the fields have been shut down for various technical reasons.

As far as I can see, I am not making any outrageous statements. My view is in line with what the industry would think. My figure is not a forecast; I am using that number to illustrate how the deficit position could change. The change is comparatively small. It adds £1.5 billion or something to the current predictions. In that context, it is not a huge number.

Gavin Brown: Let us say, for the sake of argument, that you are in charge of budgeting over the period of 2016 to 2020. Is it your view that budgeting for £4.5 billion to £5 billion a year over that period is reasonable?

Professor Hughes Hallett: Yes. That is why I use the word reasonable; it is reasonable in that sense. As you will have noticed, it is a peculiar feature of oil that you do not have to pump it—you can store it by not pumping it. It is easy to do that, and there is a natural incentive for the firms to behave like that; then, when the position improves, they will pump it a bit faster. If I were so lucky as to be running the budget, I would have that perhaps as a central projection, with one or two each side.

Gavin Brown: That is extremely helpful.

Jamie Hepburn asked you about transition costs. You have been asked some questions on that already, so I will not dwell on it for long. Given that there is disagreement between the UK Government and the Scottish Government on what those costs might be, do you think that it would be advisable for either both Governments or somebody independent of both Governments to produce some idea of what the transition costs might look like?

Professor Hughes Hallett: That is also a leading question, as I have added into the other discussion about the fiscal policy commission the possibility that in future the Scottish Parliament—not this Parliament, I guess, because it will not be the same Parliament—might think about whether there are specific problems that it would like the commission to investigate for particular reasons. If the commission were in place, that would be quite a sensible example of what it could do.

Gavin Brown: I have one final question, which you have already partly been asked. You suggested in your paper that some banks might feel that it would be safer or better to move north, were Scotland to be independent. That is your view, but have any banks, financial institutions or companies said that? I have not seen many say that publicly, but have they said that to you privately?

Professor Hughes Hallett: I have no contact with the banks, so they would not be able to say it. Some banks have moved, of course, but those are the retail banks, not the big ones.

John Mason: I want to follow up on the point about transition costs. Some costs would inevitably start on day 1, but presumably there will be others. If we were going to re-do the income tax system, would there be flexibility about whether we did that over two years, five years or 10 years and therefore spread the transition costs as we could afford them?

Professor Hughes Hallett: Sure. You do not want to do everything all at once. Apart from the cost, there is the brain power. You want to focus on one thing at a time. I am sure that the work would be spread.

John Mason: That would spread out the workload of the Finance Committee, as well.

I go back to some of the stuff that was mentioned earlier, such as quantitative easing. Mr Thomson, you used the phrase “printing money”, which has been used traditionally. A previous witness said that one of the temptations for a country that has a lot of debt is to allow inflation to erode that debt. Is it a risk for the UK that, at some stage in future, we might get a UK Government that allows high inflation to erode the debt?

Ben Thomson: You refer to high inflation. Most Governments do not allow high inflation; it is something that they cannot control.

At some stage, the UK is going to have to deal with the debt that it has in the system. There are only a limited number of ways that you can deal with the debt. First, you can grow your economy, which I do not think is in the hands of most politicians, although they can hope for it. The second way is to increase your taxation revenues, although that tends to impede growing your economy, so it is quite a difficult balance to get right. The third way is by decreasing your public sector expenditure, but the short-term effect of that, again, is that it hits your economy because the public sector is about 40 per cent of the economy.

The fourth way is by going bust and reneging on your debt. Greece has done it four times in the past 100 years, and the UK has done it once in the past 100 years—we should not forget that the UK defaulted on war debts after a loan. It is perfectly possible to go down that route. It has a higher cost, including a lack of credibility, but you can come back from it.

The last way is through quantitative easing, which will result in an increase in the volume of supply of money. When velocity of money—the circulation of money—starts to increase, you tend to get much higher inflation, which will hit savers and reduce the real debt.

13:00

We can compare what is happening in the UK and the United States with what happened in the 1930s, when we had similar banking problems.

Roosevelt came in in 1934 and used all five techniques. We are using them all at the moment, although we have not gone quite as far as Roosevelt went on most of them, so I fully expect that there is quite a bit more quantitative easing to come.

In the end, because the volume of money increases, as soon as people start spending, things turn round and banks start lending again, there will be inflation, which will hit savers but be beneficial to borrowers, including Government borrowing, reducing the real size of the debt. That is one of the tools in Government's armoury for controlling money.

Does that make sense?

John Mason: Yes, it does and it was useful.

You mentioned having some kind of treaty or agreement that would cover that kind of stuff. Would that be a good discipline, not just for Scotland but for the UK as a whole, because it would restrict what any Government could do in such a scenario?

Ben Thomson: Yes, I think that that is the argument. In Europe, consideration is being given to whether we can run monetary union better within a treaty or within a democratic process. The treaty tends to have the advantage of being clearly set out but the disadvantage of being very bureaucratic, and if people have sovereign rights they can always break the treaty—as has happened in the monetary union, because nearly all the fiscal rules have been broken by nearly all the countries in the union.

In an elected representative system for monetary union, whereby everyone joins a federation, as is the case in the United States, people get their say at the ballot box on how they want to do it. There are pros and cons of both approaches.

John Mason: Thank you. Do the other witnesses want to comment?

Professor Hughes Hallett: A treaty is useful, because it is transparent and is a point of reference. However, people can choose to break it. As Ben Thomson said, people in Europe did not keep to the treaty that underlined the stability of banks, because they discovered that it was not going to be enforced and they could get away with breaking it.

In purely strategic terms, the Greeks very nearly got it right: they could break the treaty and get their debt ratio to an extreme level but still be bailed out by someone. The only thing that they forgot was that the bail-out would come with a cost, which they subsequently found uncomfortable, although at the time they did not reckon with that. The important point about treaty arrangements is that they must be seen to be enforceable in some simple way. I can enlarge on that at great length at another time, if members wish me to do so.

The temptation to inflate away debt by quantitative easing or conventional means is always there. However, as Ben Thomson pointed out, that has significant costs, which are partly economic and partly political. No one wants to be accused of being the Government that created inflation. That is why the Americans have put a lot of emphasis on the exit strategy, which is a technical way of unwinding the position without causing inflation. I imagine that that is what will happen.

Of the different solutions, the only one that enables us to make progress without getting into all the difficulties that we have talked about is growth and structural reform to make the economy work more efficiently. That is why the issue is being talked about a lot in Europe. The problem is that a lot of the time that is not done. It was done very effectively in Germany and some of the Scandinavian countries, but it is not an easy path.

John Mason: Ms Tetlow, in your paper, under the heading "Fiscal sustainability of an independent Scotland"—it is page 14 in my papers, but I think that it is page 4 of your paper—you described "the most optimistic scenario", in which Scotland experiences high migration,

> "takes a share of debt equal to 40% of Scottish national income"

and

> "pays the same (5%) interest rate on its debt as assumed for the UK government".

Those two things do not strike me as being the most optimistic scenario. One witness suggested to the committee that, instead of taking a share of the debt, Scotland should get lump-sum compensation for past exploitation—or whatever word one might use to describe it. The most optimistic scenarios, therefore, would be having no debt or starting off with a lump sum. Indeed, it has also been suggested to us that other small countries pay lower interest rates, so I would have thought that the most optimistic scenario would include having a lower interest rate than the UK, if not on day 1 then on day 2, 3 or 4. Did you not look at such optimistic things at all?

Gemma Tetlow: We did not look at a scenario in which Scotland took no share of the debt, although that is clearly a possible point on the scale. As for interest rates, I have seen no analysis that suggests that Scotland would have a lower interest rate. I presume that, relative to the UK, it would have no record with market players and therefore might face a slightly higher interest rate—although that would, of course, be very much dependent on the level of debt that Scotland would have, which would affect the riskiness of lending it more money.

The scenario that you highlighted was the most optimistic that we considered in our publication. In fact, some of those assumptions are quite a lot more optimistic than what one might think of as the baseline case for current UK Government policy, particularly with regard to the levels of migration. Furthermore, because it applies to the whole of the Scottish economy, including the current offshore economy, our productivity growth assumption implies quite high levels of onshore growth, particularly given that offshore production is going to start to decline over the next few decades.

I am afraid that I do not know what the answer would be if Scotland started with zero debt. However, one factor that feeds into this and which I think would still play out in a zero-debt scenario is that, although the level of debt would be very much affected by starting at zero rather than at 40 per cent, the trajectory of the Scottish fiscal position would start to differ slightly from the UK's because deficits would start to accumulate more quickly in Scotland as a result of certain ageing pressures and declining revenues from the North Sea. In other words, the trajectory of Scotland's fiscal position might be of as much concern to those lending money to the Scottish Government as its exact fiscal position at that point in time.

John Mason: But would the trajectory of Scotland's fiscal position not be changed if it started with no interest payments?

Gemma Tetlow: It would, and that could certainly be true for several decades. I am afraid that I would have to go back and check my numbers.

John Mason: I accept your point. As has been discussed, if we had no history of borrowing—although I think that we are going to get borrowing powers quite soon—we would have no debt record. Perhaps I could look at the situation from a personal angle. If I had no debt and I went into a bank to borrow some money, the bank would have no record to look at. If, on the other hand, the convener had a huge amount of debt, the bank would at least know who he was.

The Convener: Riotous living. [*Laughter*.]

John Mason: I follow that logic but, surely, once things settled down, those who lend the money would look at the whole package: how much debt we had, how we managed it, how we had been repaying it and so on. I presume that that is why interest rates in a small country such as Austria are lower than those in the UK.

Gemma Tetlow: That might well be the case, but I suggest that you ask people who are better qualified than I am to comment on that.

Professor Hughes Hallett: Because the currency in Hong Kong, which I was forced to look at, is tied to the US dollar, it is as if Hong Kong itself is part of a common currency area. It has lower interest rates, precisely because it manages its debt better. It is an important point and, with all due deference, I would expect that to be the case for Scotland.

John Mason: I think that people are ready to go, but I want to raise a final point about the accuracy of forecasts. You are all experts, and most of the committee members are laypeople. How much faith do you think we should put in forecasts? My rule of thumb is always to add plus or minus 3 per cent, but I accept that one cannot always do that. The OBR produces fan charts, which tend to emphasise uncertainty. Last week, Lady Susan Rice told us that she liked such charts, and I would be interested in hearing what all of you have to say about them. I note that the Institute for Fiscal Studies, in particular, produces forecasts that are definite lines. Do you not accept that there might be some uncertainty in there?

Gemma Tetlow: In general, I agree entirely that something like a fan chart around a central projection is an extremely useful way of highlighting the extent to which there is great uncertainty. The OBR now produces fan charts on its projections using a methodology that we pioneered—the OBR has taken that on from us.

Forecasts for the next five years are difficult to do; projections that look forward 50 years are even more uncertain. In a sense, although we did not include fan charts in it, we presented in our report a number of scenarios and studiously avoided using any term such as "a central forecast" in order to highlight the fact that there is a range of uncertainties. The value of doing those longer-run projections is not that you believe any one central number; rather, they simply allow you to pull together all the different facts that might be important and highlight those elements that ought to be of concern to policy makers who, inherently, must make a judgment about the stance of fiscal policy in the short and long term. Politicians need to take account of those risks and pressures. Projections make those risks and pressures clearer to people. It is not that you believe the precise number; they are simply a way of clarifying some of the issues.

Professor Hughes Hallett: I agree. I like to use fan charts. They can be embarrassing because, if the fan spreads out too much, you lose credibility, except for in the immediate future when it is still quite narrow. Nonetheless, they are important.

It is crucial, at least for me and for policy people, to understand what is causing the uncertainty and driving the width of the fan chart. It will not be entirely random, although some of it will be. Almost certainly it will reflect uncertainty about some other factor that is feeding into the forecast, and you need to know about that.

As Gemma Tetlow says, one way to present that is to give a central forecast, along with a few strategic alternatives saying, "If this were to happen, you would be up here; if that were to happen, you would be down there." If you are clever, you will say that it will happen "with such and such a probability". That is a good way to go.

John Mason: Thank you very much.

The Convener: I have a final question. We have focused more or less on the independence scenario, but we may be faced with a no vote scenario. As Gemma Tetlow will know, on 5 March, IFS director Paul Johnson gave evidence to the committee. I asked him about the financial projections for Scotland's devolved budget. I said:

"'Even with the Chancellor's mooted £12 billion of further cuts to social security benefits, the implied cuts to public services ... to 2018-19 would mean departments facing budget cuts of 17.1% on average.'"

He responded:

"I have no reason to believe that the numbers would be significantly different in Scotland."—[*Official Report*, *Finance Committee*, 5 March; c 3760.]

What does that imply for jobs and services in Scotland through our devolved budget if the situation remains the same after 18 September?

Gemma Tetlow: Since Paul Johnson gave evidence in March, we have had a new set of forecasts from the Office for Budget Responsibility that would change slightly the numbers for the UK. I am afraid that, off the top of my head, I cannot remember exactly what those figures are.

The UK Government has pencilled in plans for a further squeeze on public spending after the 2015 election. As it stands, that will come not from welfare benefits but from public services almost by default, because we have not had specific announcements on tax or welfare spending. We do not know where the cuts will come; we do not know how they will be allocated across departments. That will be the key decision for whoever is elected to government at Westminster after next May. Without knowing how those cuts are distributed, I am afraid that it is very hard to know what that means exactly for employment and the level of public services. It is clearly a further cut to public service spending and that has costs for the level of service delivery.

The Convener: The cuts are likely to be significant, with Scotland assuming that those cuts would be the same across the UK departments.

Gemma Tetlow: The precise settlement for Scotland would presumably depend on how budgets are allocated across the UK, whether through the current or a revised Barnett formula. I do not know the precise numbers for Scotland, but I suspect that the picture would be similar.

13:15

The Convener: I do not want to get into the Barnett formula but, assuming that everything stays the same—all else being equal—the likelihood is that Scotland would have a significant further reduction to its budget.

Gemma Tetlow: Based on what is pencilled in, the UK Government's plans are to squeeze public service spending across the UK after the next election. We do not have a lot of detail about how that would be achieved. I suspect that that would be the case for the part of the spending that goes to Scotland as much as it would be for what goes to the rest of the UK.

The UK Government is doing that in part to achieve a surplus on the overall fiscal balance by 2018. The Labour Party, for example, has suggested that it would seek to achieve a slightly less tight fiscal position by 2018, which would give it more scope to spend a little bit more if it wanted to. What happens after the next election will depend very much on which party is in power and what its priorities are.

The Convener: With that, I conclude by asking whether anyone wants to make any final points. I see that no one does—perhaps you have all been exhausted by the session.

I thank our three witnesses for their hard work in answering so many different questions—I really appreciated you being here. I also thank committee members.

We will have a one to two-minute suspension to allow the public, witnesses and official report to leave.

13:16

Meeting suspended until 13:18 and continued in private thereafter until 13:35.

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