



The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

FINANCE COMMITTEE

Wednesday 29 October 2014

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FINANCE COMMITTEE
26th 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 (Scottish Fiscal Commission)

Professor Campbell Leith (Scottish Fiscal Commission)

Professor Iain McLean (University of Oxford)

Lady Susan Rice CBE (Scottish Fiscal Commission)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Finance Committee

Wednesday 29 October 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 26th meeting in 2014 of the Scottish Parliament's Finance Committee. I remind everyone present to turn off any mobile phones or other electronic devices.

Our first item of business is to decide whether to take items 4, 5, 6 and 7 in private. Are members agreed?

Members indicated agreement.

Draft Budget Scrutiny 2015-16

09:30

The Convener: Our second item of business is to take evidence from the chair and members of the Scottish Fiscal Commission in relation to the commission's report on forecasts for the devolved taxes and for non-domestic rates. I welcome to the meeting Lady Susan Rice CBE, Professor Campbell Leith and Professor Andrew Hughes Hallett.

Committee members have the report, so we will go straight to questions. As is the custom on the committee, I will ask questions first. Members can come in subsequently if there are any questions left to ask—I try not to steal all the good ones at the start.

The commission describes its approach to consideration of the Government's forecast as one of

"enquiry and challenge, followed by response, followed by further enquiry and suggested improvements."

Do you intend to publish details of the inquiry and challenge, as recommended by the committee?

Lady Susan Rice CBE (Scottish Fiscal Commission): Let me respond in the first instance and then I will turn to my colleagues. Are you happy for the three of us to have a conversation with you?

The Convener: Yes. I should have made that clear at the start. One or more people can comment; the questions are not directed at you alone. You can answer, and if your colleagues also wish to answer, that is great. You may not wish to answer certain questions at all if they can be more appropriately referred to the professors on either side of you.

Lady Rice: That is very helpful. I will at least start off in response to the question.

The words that you quoted are mine. The three of us drafted the report, but we took on different bits and sections and then made it into—we hope—one voice. I was simply trying to reflect the nature of how we do things. Some fiscal bodies in other countries and places look at forecasts after the fact, but our job is to look at them before the fact. Those words were meant to point out the nature of what we are doing.

We started our work once the forecasters were ready, in the latter part of the summer, by having a presentation from them on their approach to forecasting—their models and so forth. Inquiry and challenge was a matter of asking a lot of questions, such as, "What do you mean by this?", or, "Have you considered this or that?" Out of all

the to-ing and fro-ing, we ultimately drew our conclusions. For instance, one conclusion that is very clear in the report is that these are new taxes without decades of historical data. That is a challenge, and data is an issue. Out of the inquiry and the challenge came some of our conclusions. In summary, that is what is encompassed in the report.

If you are asking us to publish something more specific, the answer is that if you tell us what you would like, we can do it. If you would like a summary of meetings or conversations that we had with the economic forecasters, for instance, we can prepare something of that sort.

However, we felt that we had reported overall on the nature of how we worked, which was to challenge beforehand. The results of all those conversations were the results and conclusions that we put into our report.

The Convener: Did your forecast change as a result of that inquiry and challenge?

Lady Rice: Well, we are not forecasting—

The Convener: I should have said the assessment of the forecasts. Quite clearly, there are two different forecasts: the Scottish Government's forecast on new taxes, for example, and the Office for Budget Responsibility's forecast. As you know, there is a £51 million differential between those forecasts. My question is whether your assessment of those forecasts changed.

Lady Rice: I will ask my two colleagues to respond, because to begin with they each took a tax, although we shared all of this—at the end of the day, it was very much a committee effort.

Our understanding of what was happening changed absolutely as we had the conversations. Some of the economists came back to us to answer more questions and give us more information as we delved into the subject.

In terms of our assessment, we started by finding things out. We did not start by saying, "This is good or bad"; we started by saying, "Help us understand what you've done." You cannot start anywhere else.

The Convener: Absolutely.

Lady Rice: I would not answer your question in exactly the terms in which you posed it. Let me turn to one of my colleagues for an answer.

Professor Campbell Leith (Scottish Fiscal Commission): The nature of the inquiry took several forms. In addition to written submissions from the Government to us, and the queries that we wrote in response, we had meetings. Those essentially took the form of an academic seminar, in which we put points of clarification to people during the presentation of their forecasting

methods. That was followed by a long series of questions.

We also received spreadsheets containing the models from the Scottish Government. In a sense, that is all part of the inquiry process, even though we were not specifically questioning the Scottish Government economists at that point but were just looking through the models.

A wide range of activities took place in the inquiry. The initial part of that involved not so much a review of the forecasts, because they were not finalised at that point, as an exploration of the methods. A large chunk of the initial part of our inquiry involved looking at how the Scottish Government proposed to forecast, in a general sense. What were the underlying methods? What techniques were the forecasters using, and what models had they built to enable them to do that? The bulk of the inquiry was focused on that.

The forecasts were finalised relatively late on in the process, and we looked at those in light of the discussion about methods that had taken place.

The Convener: Lady Rice said that how things developed changed quite considerably during that process. Can you give us a bit more detail about how that came together?

Lady Rice: There was not a big window of opportunity for any of us to come together, understand the issues and produce our report. It was a very intense period—it did not happen over a period of many months. We were formed only in July, when we had our letters of appointment.

The Convener: I am trying to remember the specific words that you used—I am trying to find that in the depths of my short-term memory. You said that the way in which you explored the issues in the inquiry changed or evolved a wee bit over the period.

Lady Rice: Yes. Sorry. Let me make that clear if I have not done so.

We started out by trying to understand how the forecasters were coming at it—what models they were using and how they were approaching the forecasts. We could not really make a judgment about how reasonable their forecasts were unless we understood their approach. That was the early part of our engagement. Then, as Campbell Leith has just said, when the forecasters had more or less concluded their forecasts, we looked at those and needed to make a judgment about whether they were reasonable.

You will have seen our conclusions in the report. In one area, we pointed out that the forecasts were within the bounds of reasonableness but quite optimistic, and that was responded to. That was the outcome of the second phase, when we applied to the forecasts what we knew about the

forecasters' models and their approach. Is that clear? I am sorry if I am not making it clear.

The Convener: I think that it is me who is not so clear, rather than you. However, I will move on a wee bit.

Throughout the report, you talk about data. Obviously, there is frustration—which the committee has shared for a long period—about the sources and quality of data that is available specifically to allow us to look at and drill down into Scottish figures. Was all the information that you considered necessary for your report made available in good time by the Scottish Government?

Lady Rice: The point about data is a very important one, as I indicated in my answer to your first question. We are talking about taxes with a new shape, so there is no long history of data that could feed into the models that the forecasters were using. As my two colleagues will tell you, economists want a long series of data. That makes them more comfortable with the forecasts that they come out with.

Given that fact, we and the economists had a lot of conversation about what data they had, what their sources were, whether there was anything better, whether people co-operated with them when they went to acquire data, whether it was the best data that they had and so forth.

I will make two other comments before I turn to Andrew Hughes Hallett to add a little more. First, I have prompted a series of meetings with some of the agencies that have started to provide data to the Government economists. Those conversations are continuing. I have had a couple of meetings with the Scottish Environment Protection Agency, and I have a further meeting coming up. Revenue Scotland and Registers of Scotland are also involved. It is for us to make a judgment about how willing, happy and responsive they have been. There has certainly been a willingness on all sides when it comes to the sources of data.

In the past—for reasons that we can understand—the OBR has, in some instances, gathered data, made a proportional cut and applied that to Scotland. That is not the same as having Scotland-only data, which is where we all want to be. That could not be the case in the first round.

My second point is that we had a great deal of debate among ourselves, sometimes well into the night, about what forecasters and economic modellers should do when they do not have a perfect data set—that is often the case, because life is rarely perfect—and what the best approaches to that, and ways of dealing with it, are. I ask Andrew Hughes Hallett whether he would like to say something about that.

Professor Andrew Hughes Hallett (Scottish Fiscal Commission): To go back to the initial question, we want long data series if we can get them because we are trying to look for some regularity in the data. In a short period, it is not possible to tell whether the variation is just noise or whether there is something irregular at play. Therefore, it is important to go back as far as possible.

It sometimes takes a while to discover whether the data goes back in time—we might not know whether it does, or it might be hidden somewhere. For example, we have discovered that the housing data from Registers of Scotland could go back to 1617—it goes a long way back, but it is very patchy.

Lady Rice: It is very patchy before 2003.

Professor Hughes Hallett: Apparently, it is pretty good as far back as 2003. Beyond that, we have to ask how much regularity we can get out of the data.

In other cases, such as housing, it is obvious that some financial data is desirable. However, such data might not exist or, as Susan Rice said, it might exist only at the United Kingdom level. Up until now—until we can collect some of our own data or find some other way of getting it—the best that we could do was take a Scottish cut of the data, and such data reflects conditions in the rest of the UK rather more than it reflects Scottish conditions. Therefore, with housing, the numbers might get blown apart because of the London effect, and that leaves us asking whether the cut that we have taken is good enough or whether we can make an assumption that we believe takes out the London effect, although it will not be possible to be sure about that until we can hold a post mortem.

That is a very long way of saying that it is inevitable that there will be compromise. We know how, ideally, we would like to do things. When we discover that that is not possible, the question is how far we are prepared to compromise. I think that the methods that the Scottish Government people have used up until now are reasonable, but that is not to say that they could not be improved. Our job for the coming year is to see what we can do to improve them. Assessing how we can sensibly go forward in a reliable way will be a bit of a—excuse the phrase—touchy-feely process.

The Convener: I mentioned that the difference between the forecasts for receipts from the devolved taxes is of the order of £51 million—the Scottish Government forecasts a figure of £558 million, whereas the OBR forecasts one of £609 million. Which of those figures do you think is the most accurate?

09:45

Professor Leith: I will try to answer that. Essentially, there is a continuum of ways of forecasting, and the Scottish Government and the OBR are at opposite extremes of that continuum. The OBR has a large macroeconomic model with hundreds of equations describing all aspects of the economy, largely because the OBR has to forecast all macro variables plus the whole range of fiscal variables that it is interested in. The bulk of its work is focused on that. In forecasting the devolved taxes, given the limited data that there is, it tends to apportion some kind of share of UK projections to Scotland, which may be just a historical average but may have some slight drift in it.

On the other hand, the Scottish Government has looked at each tax on a case-by-case basis and has used the data that it has for that tax to build small, simple statistical models. Sometimes, it has simply extrapolated historical data to project those variables forward.

Those are completely different approaches and it is not obvious which one will produce the best forecast. Horse races between those forecasting techniques are conducted in the literature and it is not automatically the case that a big, 100-equation model will dominate simple statistical analysis. No one approach is better than another; essentially, they are fundamentally different ways of doing forecasts.

Turning to specific taxes, the OBR's forecast for the land and buildings transaction tax is slightly higher than the Scottish Government's forecast. However, the OBR is using UK-wide projections, and the UK as a whole has a more buoyant housing market than Scotland does. The OBR is shading those projections down a little bit for Scotland's share but not to the extent that it appears the Scottish Government is doing implicitly, by building up from Scottish data. Those are the fundamental differences in how they are doing things.

The Convener: I know that there are fundamental differences. To be honest, your answer was almost "How long is a piece of string?"

We are quite keen to know which forecast you think would be more accurate. There is a difference of some 15 per cent between the residential transactions revenue forecast from the OBR and the forecast from the Scottish Government, and there is a 9 per cent difference between the landfill tax forecasts. Those are quite substantial differences in terms of proportion. These are fairly small taxes but as we go forward with other devolved taxes, such differences will be very significant. That is why we are quite keen to

get the most accurate forecasting and to get your assessment of which forecast is able to deliver the most accurate prediction of where we will be.

Professor Leith: In order to be accurate, what are called standard errors need to be attached to the forecasts, which neither the Scottish Government nor the OBR does at present. It is very difficult to do that with large-scale macroeconomic models, and the Scottish Government has insufficient data to build statistical models that can assess the statistical accuracy of its forecasts. The Bank of England can attach errors to its forecasts when it has sufficient data in a small-scale model. That is how it produces its fan charts, which forecast the upper and lower bounds of inflation.

My conjecture would be that if you drew similar fan charts and did proper statistical analysis, the fan charts would get wide very quickly and would encompass both sets of forecasts. They are not statistically different. They look largely different but, statistically, they are not different.

Lady Rice: I will add a very small point. In one instance where there is not a lot of Scottish data in terms of bulk, the Scottish economists took a three-year average, which is a very sensible approach. They were quite conscious of the limitations of the restricted data that they had.

The Convener: Yes, I saw that in the report.

I want colleagues round the table to have an opportunity to ask questions, so I will touch on just one other thing—non-domestic rates. The commission's report talks about buoyancy and suggests that the increase is on the optimistic side. Indeed, Mr Swinney has reduced his forecast by £83.5 million. The report also says:

"NDRI revenues are five to six times larger than the LBTT and SLFT taxes combined. It would therefore pay to make them as reliable as possible, as quickly as possible."

I am not sure why you suggest that because, as Mr Swinney said on 9 October when he presented the draft budget, some £13.1 billion has been collected in non-domestic rates income since 2008, yet the cumulative variance has been only £40 million, which is 0.3 per cent. Professor Leith talked about margins of error and we have talked about a difference of 15 per cent between the OBR and Scottish Government LBTT predictions, yet on NDRI we are talking about only a 0.3 per cent variance. Why are you as a group so concerned about that issue?

Professor Leith: In essence, it is because the taxes are on different activities. Land and buildings transaction tax and landfill tax are taxes on transactions, whereas non-domestic rates are a tax on the stock of rateable floor space, so what changes in the forecasts is the rateable floor space, which is to do with new business premises

coming online and so on. The forecasters have to forecast the change in domestic rates rather than the level of domestic rates. Perhaps our report is slightly misleading in suggesting that there is volatility in the aggregate level of that. In looking at the accuracy of forecasts, we should have compared the change in non-domestic rates tax revenues with the tax revenues from the other taxes.

Professor Hughes Hallett: The variance might be 0.3 per cent, but it is quite a lot of pounds. The tax is much larger, which is why we are concerned about it. I am slightly behind the times on this, but I think that you said that the figure involved is about £40 billion, convener.

The Convener: No, it is £40 million out of a £13.1 billion sum over six years. In that time, we have had a recession and all the rest of it, yet the accuracy of the figures is remarkable. It is remarkable to predict such figures within 0.3 per cent.

Professor Hughes Hallett: Yes, but that is over a number of years. I do not have the figures for individual years, but they might cancel each other out. There might be quite a lot of variability year by year.

Of course, we are talking about forecasting for one particular budget. We can get lucky, or in this case perhaps unlucky—I am not sure which it is. That is why we are concerned about the issue. The number of pounds could be quite large.

The Convener: Have the predictions been way out in any year? Has Mr Swinney predicted significantly higher income than was delivered? I am not aware that that has been the case.

Professor Hughes Hallett: I do not know the numbers.

Lady Rice: We do not have those numbers, but the issue will bear looking at. As we work on our work plan for the coming 12 months, we will definitely pick up on that point.

Professor Hughes Hallett: We certainly need to go back into it. As I said, we have to do a post mortem on all three taxes to see how well they performed. The report took quite a long time to produce but we had to do it in a month. If you wanted to come and join us at midnight, you would be welcome.

The Convener: We all appreciate the work that you are doing—I am not trying to criticise.

Professor Hughes Hallett: You have put your finger on the right issue. We need to look back and consider how well the taxes performed. The phrase that you picked out is mine. I am concerned that the impact on the budget could be a lot larger.

The Convener: Thank you. I will let my colleagues come in.

Jamie Hepburn (Cumbernauld and Kilsyth) (SNP): I thank the commission very much for its work. You have been able to “endorse as reasonable” the Scottish Government’s forecasts. On that basis, I will return briefly to the difference between the Scottish Government and OBR forecasts. The convener explored that fairly thoroughly but, for absolute clarity, I will go back to the points that Professor Leith made about the difference in forecast methodology. Is the difference explained simply by the fact that the OBR comes to a UK assessment and then apportions a proportionate share of that to Scotland?

Professor Leith: Largely, yes. That is the fundamental difference between the two approaches to forecasting. There are slight differences in using a three-year moving average as the base year for forecasting non-residential transactions—the OBR does not do that—and there are other subtle differences. The landfill tax forecast is based on a Department for Environment, Food and Rural Affairs model for the OBR, but it is built up from SEPA data for the Scottish Government. There are other small differences, but the fundamental difference is that the OBR uses a big, macroeconomic model and scales a portion of that for Scotland, whereas the Scottish Government economists start with a small set of data relating just to the devolved taxes and roll that forward in forecasting the taxes.

Jamie Hepburn: Does the OBR apportion Scotland’s share on the basis of Scotland’s population equating to just under 9 per cent of the UK population?

Professor Leith: No. It has historical data for the tax revenues raised in Scotland from a particular tax relative to what was raised in the rest of the UK and it uses those historical averages, although in recent forecasts it has tweaked the figures slightly. For example, the UK housing market is now more buoyant, so the OBR has reduced the share of stamp duty land tax apportioned to Scotland on the basis that the Scottish housing market has not been as buoyant as the housing market in the rest of the UK has been because of the London effect.

Jamie Hepburn: The OBR still appears to think that the Scottish market will be more buoyant than the Scottish Government thinks it will be.

Professor Leith: Yes—the OBR has not scaled the figure back.

Jamie Hepburn: The convener touched on the frustration that is felt at not having access to data, which is a major theme of your report. You have

suggested that the situation should improve over time, but how long will that time be?

Lady Rice: That is the question. How long is a piece of string? Thirty years from now, there will be a series of data that covers 30 years, but none of us might be sitting around this table then. We need to go in and do a drains-up review to see whether anything more could have been done for this round to get more data, to get it differently or whatever. How does one accommodate, in a forecasting sense, the fact that we do not have the ideal set of data? Are there ways to do that? We cannot predict the future—we just take our best shot with what we have in order to come out with a picture of what the future might look like.

The data will improve. I have had conversations with SEPA and I will go out to test this on the ground, as it were, in a couple of weeks. SEPA will be much closer to the landfill sites than the OBR has been able to be and it will see the relationship between the tax and what goes into those sites. We believe that it will have a truly on-the-ground ability to reflect what is actually the case. That is not to fault either side for the differences; that is just the way that it has been.

The data will improve over time, but the improvement will be gradual and we will not get the data for those 30 years until the 30 years are up.

Jamie Hepburn: Maybe it is unfair to ask you the next question—feel free to dodge it.

Lady Rice: I did not know that we could do that.

Jamie Hepburn: Feel free to answer the question if you want. You have not heard it yet, but it is not that difficult.

It has been suggested that there should be a dedicated statistical agency for Scotland to look at data not just in the area that you are looking at but more widely. Would that be useful for your commission, for other public bodies, for the public at large and for parliamentarians?

Professor Leith: Forecasters need data. It does not matter where it comes from. If a new statistical agency generated that data, that would be a good thing.

Lady Rice: There is already Registers of Scotland, whose job is to hold, create and analyse data. I am avoiding giving a yes or no answer. People would have to ask whether there would be an overlap with what is already done, whether what is already done is good enough or whether another agency would be helpful.

10:00

Professor Leith: Over time, the new taxes will generate revenues, and new data will be

generated. However, before all this happened, transactions were taking place in the Scottish housing market, landfill was being sent to landfill sites and taxes were being paid on all that. I presume that those transactions have been recorded somewhere; they might not be easily accessible but, if that data exists in some raw form in existing bodies, it would be good to encourage those bodies to dig it out and put it into some usable form.

Professor Hughes Hallett: My experience is that often more data is available—somewhere—than we might think. Of course, it is not until people get into one of these forecasting exercises—I should point out that this is the first time that it has been done—that we know the questions that we want to ask and realise that we want this rather than that data.

There will be improvements in that sense, and there will be even more improvements when the process has been gone through two or three times—I should say that that will be three years, not 30 years, down the line—and what I might call the ad hocery in some of the variables has been refined. All those things will happen more quickly than other things; there will not be the perfect answer.

As for establishing a statistical agency, whether people want to pay the money for a whole other agency is one question, but it would be useful in putting an explicit focus on Scottish data instead of data that has been derived from elsewhere, perhaps from the UK, and just carved up.

Jamie Hepburn: You say in your report that you “would welcome feedback from any reader”.

I hope that I have got the terminology right, but I believe that Professor Leith previously talked about peer review. Have you had any such feedback?

Lady Rice: We have carried out an exercise to look at reviews of other fiscal commissions or similar bodies in other countries. They are all slightly different and there is not one that is absolutely like ours, but the OBR, which is closest to our world, has been peer reviewed by a Canadian with experience. We have all had a look at that review; it was carried out five years in, which gave the OBR the chance to establish itself and work out its methods and provided an opportunity to find out whether it had got things right or wrong, whether it had changed or adapted and so forth. We agree that such a peer review is absolutely appropriate but, as we have been operating for only two or three months, I guess that it will not happen in the next two or three months.

When we published our report, we did not send it out widely; instead, we put it on our website and sent out a little press notice to ensure that anyone who was interested could find it. However, I sent it to the OBR for review. Over time, as we continue our conversations with the other bodies and agencies with which we have started to have a relationship, we will request feedback and input. It would be good to get that sooner, but a formal peer review—with capital letters—will be some period down the line. I do not know exactly when, though.

Jamie Hepburn: I was not necessarily suggesting a formal peer review. In any case, you essentially answered my question when you said that you had sent the report to the OBR. People are looking at this and you are getting feedback.

Lady Rice: Indeed. We also received feedback in our recent conversations with Revenue Scotland and Registers of Scotland, and we welcome that. After all, as I have said, this is a first for all of us, and the more people come into the conversation and tell us what they think, what works and what is or is not clear, the better we will do this the next time.

John Mason (Glasgow Shettleston) (SNP): There have been a lot of questions about the amount and availability of data, and I suspect that there will be more. Continuing with that theme, I note that in the recommendations in your report on the non-residential model for LBTT, you say that

“creating a new Scotland-specific data set may be the only reliable strategy.”

However, you then say that

“That is neither a short-term nor cheap undertaking”,

which is the bit that worries me. There must come a time when having more data does not result in a better forecast, in which case spending money on getting that data would be a waste. How do you decide how much data you need? It has been pointed out that some data might already exist, although it is not available. How do we balance such things?

Lady Rice: There are many ways of answering that question but, before I turn to my expert colleagues, I should say that part of the answer concerns the quality of the data. The amount of data is important—after all, models require a certain volume of data, which is very helpful, as Andrew Hughes Hallett explained—but the issue is also about how good and specific the data is. We are beginning to see a focus on Scotland-specific data. That is important, because it means that, even if the data that we get is limited in bulk and volume, it will perhaps be better.

Perhaps Andrew Hughes Hallett or Campbell Leith wants to respond to your question about how

much data is enough and where the cost benefit comes in.

Professor Hughes Hallett: I suppose that I could say a few things. John Mason is right to pick on that element, because it was one of the weakest parts of the current forecast. If we did this properly, we would go back and say, “What kind of model do we want? How would we, in principle, forecast this?” We would see what data was required and then no doubt discover that it did not exist and that we would have to dig for it. I am not sure that we would do the digging, but we can tell people what to expect.

It is a bit difficult to give you an answer *ex ante*, because neither we nor the Scottish Government people have carried out that exercise. At that point, however, we might well find that we desperately need Scotland-specific data, and we would need to set up a project on that, which we might commission. That is how I would go about this; I would start at the model end instead of trying to find all the data that we can imagine on what is affecting the non-residential sector.

John Mason: As the convener pointed out, the forecasts for non-domestic rates income have been quite accurate over six years. Professor Hughes Hallett suggested that there might be many fluctuations in that, but is that important? I realise that, if the fluctuations were too great, they would affect the borrowing limit, but should we not be more interested in ensuring that we have a balanced budget over six years or whatever? Is one year so important?

Professor Hughes Hallett: We are interested in having a balanced budget over time, but I am not sure that the Scottish Government is in such a position. It has to balance the budget as best it can every year because, in effect, it cannot borrow. The amount of borrowing that is allowed under the current arrangements for spending is tiny; indeed, at 0.5 per cent of gross domestic product, it is scarcely visible to the naked eye. The Government is constrained, which is why I made the comment that you have highlighted.

If the Government were asked to follow convention and went to a model in which it balanced the budget over the cycle—let us forget the last financial crisis, which was a bit of an extreme event—things would be a whole lot easier, and we would be interested in performance in exactly the way that you have described. I need to go back and check how much fluctuation there was year by year.

John Mason: It was just a general question.

Professor Hughes Hallett: That was a general answer to it.

John Mason: One or two things about landfill tax jumped out at me from your report. First, I was concerned about your comment that SEPA is reporting data with a two-year time lag. Can you comment on that?

Lady Rice: That came out of our explorations of data sources. As you know, SEPA has been changing the way in which it gathers landfill data. Something that I think we will all agree is very good—I certainly think so—is that, unlike the OBR, which looks only at landfill as reported and says that the tax is such and such, SEPA looks at illegal landfill and cases of people breaking the rules. As I understand it, there will be a bigger penalty—or tax payment—for such activity. SEPA is therefore in the process of changing its approach. It has been developing an approach in which it will go out, visit and view sites, and that will lead to some difference.

That was a comment about what has happened. The approach is already being refined, and it will continue to be refined.

John Mason: So it looks as though the data will come out more quickly in future.

Lady Rice: I cannot tell you about the time lag, but there is a very important and more general question about the timing of the availability of data. Our specific point was about SEPA, which is, I believe, thinking about the timing. However, data is also held by the Registers of Scotland, which has a quarterly reporting pattern. Does that pattern suit? In other words, what are the times when we all need data, and what are the times when we need data? We are starting conversations and are in the middle of conversations about when it would be best to have data and timetables.

John Mason: Is there a general problem that the data exists, but it is simply coming out too late?

Lady Rice: Yes, there is, or there could be. That is why we want to have a discussion with all the data providers and come up with a view on when the data would be most useful and effective for future forecasts. That is an issue, but that is not to say that there is a problem that led us to say that any of the forecasts was totally unreasonable. As you know, we have not said that, but there is an issue that we would like to get under, and perhaps we could influence change.

John Mason: I am sure that the committee would be interested to know whether you are getting data quickly from one area and not from another. We would be happy to make comments on that.

Lady Rice: That was about the data as it is normally reported from those areas. I hear what you are saying and thank you very much. Leave it

with us to have conversations about the regularity and periodicity of the data that comes out. If we need some muscle, I thank you for the offer.

John Mason: Thank you.

Another specific figure is the 16 per cent. If I am reading things correctly, it appears to me that the landfill waste should raise a certain amount of tax, and 16 per cent less is arriving at Her Majesty's Revenue and Customs. That also concerns me a wee bit. Are we clear about what that means?

Professor Leith: That is our understanding of the matter. Stuff is being dumped and the tax levels should be higher, but the HMRC data is in conflict with that.

Lady Rice: I—

John Mason: That makes forecasting almost impossible.

Lady Rice: I am sorry; I did not mean to interrupt. I understand where you are coming from.

There is a certain amount of waste tourism—that is the jargon term. Purveyors of waste sometimes cross borders and things become slightly complicated for the OBR, because it deals with firms that create and put waste to landfill. If those firms cross the border, things are a little harder to distinguish. That probably accounts for some of the difference. However, as I said, I have confidence that the changes that SEPA is bringing in will be much more specific and will more accurately reflect what is happening on the ground in Scotland. That is the place that we want to get to.

John Mason: My final point is also about landfill tax. If I am correct, the point has been made that the environmental folk within Government are really keen to push down the amount of landfill, so there is quite an aggressive target, and the finance folk—John Swinney and so on—basically reflect that in the budget. The two approaches are therefore exactly the same. I accept that that gives consistent government, but should the two be exactly the same or should the environmental folk be aggressive and the finance folk cautious?

Lady Rice: We have had some conversations about that. That is a very good question, as well.

I think that Andrew Hughes Hallett prompted some of the early discussion about the fact that the model took a straight-line approach that showed that, by year X, we should have only a certain amount going to landfill and where we are now. There has been some progress because of the escalation of the taxes, which has had a behavioural impact. What else does one do but show a straight line? That is really what you are reflecting.

10:15

That brings us back to the question about challenge and inquiry, which is really discussion. We had a bit of discussion about whether raising the tax significantly would have a different impact. Would firms do something else with their waste? It might or might not go to landfill, it might go down south or it might go somewhere else. We explored some of those issues. However, you asked whether the current approach is a good way to do it; it is an acceptable way to do it.

Professor Hughes Hallett: Yes. The only thing that I would add is that we need to do some backtracking on that, too. If the trend is as simple as a straight line we ought to be able to look at it and ask, “Did they keep to it or are they slipping?” I think that the word “slippage” appears somewhere in the report. At the moment, we do not really know what is happening.

The difficulty, of course, is that we do not know that those really are the targets. We know what the end target is in 25 years’ time or so, so we know two points on the line, but in principle anything might happen in between. If we put a bit of pressure on and ask, “Are you are keeping up with this?” things will eventually become clearer.

Susan Rice is right about the difficulties of knowing exactly what we are talking about, because OBR data and SEPA data are somewhat different. SEPA data is Scottish, so we presume that it is better. Therefore we hope that we are in the right place.

There is also a twist, which we do not fully understand, in that there is a difference in the mix of what is being dumped in the ground, and the tax rates differ in that regard. We do not have specific data on that sort of thing. Numerically it probably does not make a huge difference, but the effect will be a little bit more where the differences are coming.

If I was asked for my private opinion I would reckon that the SEPA approach is more appropriate for the forecasts, but I cannot prove that—yet. We might be able to prove it later.

Lady Rice: The issue is very much on our agenda and has been discussed.

John Mason: Thank you.

The Convener: Michael McMahon is next.

Michael McMahon (Uddingston and Bellshill) (Lab): My questions have been asked—by John Mason—and answered.

The Convener: Okay.

Gavin Brown (Lothian) (Con): What happens next for the Scottish Fiscal Commission? You

have produced your report to set alongside the draft budget. What is next in your workstream?

Lady Rice: A number of things. We have already had a bit of a drains-up session about what we did—there was a very intensive effort to get the report out. From talking to the fiscal unit in the Government, my understanding is that the unit will shortly have its own drains-up about the process, which I think was intensive for that team, too. We have agreed that we will then come together and talk about what worked, what did not work and how we can work together more effectively, if that is needed. Our primary assumption is that we want to start much earlier for next year’s budget. We will be able to do that next year; we could not start early this year.

We are continuing to create and develop what I call relationships with our relevant organisations and bodies—I mentioned some of the Scottish agencies. We spoke to the chairman of the OBR at the beginning of the process in August, and we have been in touch and will talk to him more fully.

We have had a conversation with the Parliament’s budget unit—that is the wrong title, but I am talking about Simon Wakefield’s unit, which looks at the expenditure side of the budget. We want to make sure that we know what people are doing, to see whether anyone has ways in which they can help us or feed into our work.

We have been in touch with the interparliamentary finance network, which is the network of the UK nations’ fiscal and budgetary bodies. IPFIN has a get-together in November, to which I believe that I will be going—IPFIN invited me—so that we can go, meet, talk and find out.

We have been in touch with the Organisation for Economic Co-operation and Development, which has a get-together in spring. Again, we have been invited to that, and we think that it will be useful, because we can learn from fiscal commissions from a number of countries. When the Finance Committee was doing work on whether to set up a fiscal commission, I think in February, you took evidence from the Swedish and Irish commissions. We have been in touch with both commissions. In fact, Andrew Hughes Hallett has spoken to the Irish commission and we have some paperwork from the Swedish commission. Part of our work is to find out more about how others do it. It is about building relationships, reaching more widely around the networks, understanding what we need and want, and having the right timetable to go into next year’s budget round.

I want to pick up on some of the questions that you are raising with us this morning, some of which came out of our report. The core of what we need to do is to explore those questions and find some answers. How much data is enough? What

do we do when we do not have it? These are important questions for the future. We will set out to do all of that.

The other part of our work programme might seem like an aside but it is important. As I think the committee knows, we are being hosted at the University of Glasgow, which has been very co-operative and is in the process of giving us a little office and helping us to find a couple of research assistants. We need to continue that process until we are actually functioning there. We have a website, which, as you might have noticed, does not have very much on it. However, we got the report out at the right time, which was what really mattered, and our three names are on it. We want to do a little bit more with the website.

If anyone has any suggestions about what they would like us to do, please feed them in.

Gavin Brown: Thank you.

A couple of members have asked about the differences between projections from the OBR and the Scottish Government projections for devolved taxes, and theories have been suggested for those differences. I am looking at the tables that I have in front of me. The OBR table is from March of this year and I presume that the Scottish Government table is from September or October. The OBR table is on stamp duty and land tax, and the Scottish Government table is on land and buildings transaction tax. Could either of those factors go some way towards explaining the differences?

Lady Rice: The simple answer is absolutely yes. The Scottish data will not all come from one point in time, whether it be 1 August or 1 September or whenever. The organisations will have done their best to get the best and most up-to-date data that they could, but there will be a timing difference and you are absolutely right that that makes a difference.

Gavin Brown: Towards the bottom of page 4 of your report, you talk about the residential model for LBTT. Paragraph iii) says:

“the relatively high tax rates applicable to the upper band of the new LBTT may also induce an additional behavioural response which has not been factored into the forecast.”

The committee has talked about behavioural response and quizzed others on it. Were you able to see whether any work was being done on the behavioural response to LBTT and landfill tax? Are you saying that none is being done but you think that it ought to be done in future?

Professor Leith: The formal techniques that the Scottish Government is using do not include any behavioural responses. It is not that kind of modelling.

On the housing market side of things, the Government has looked at various models that are more behavioural and structural and which would include the kind of effect you are asking about. However, it has not been particularly successful in finding workable versions of those models—such models are typically difficult to develop successfully. At the moment, the Scottish Government does not have such models and we are encouraging it to look into the possibility of developing them.

Professor Hughes Hallett: One of the reasons for this not being at the top of the agenda is that the value of the transactions in the top band is rather small, so the focus has been on other things first. If there was a behavioural response, I presume that it would be driven by the relatively small difference between the tax rates in the top band and those in the next band down. The difference between those bands and the one below that is rather larger.

Your question is the right one, but the answer might be because of a different bit of the distribution. That does not help you very much.

Gavin Brown: You said that you wanted to see enhanced forecasting methods. One of the main areas that has been talked about is data, so I will not ask about that. Other than in relation to data, which it will obviously take a degree of time to get, are there any other specific obvious areas where you think that the current forecasting methods could be improved for next year?

Lady Rice: We have discussed data. If there are ways to bring in any of the behavioural aspects, that would be helpful. That would apply to each of the taxes—there are potentially different behavioural responses to each of them. I turn again to my colleagues to give you a fuller answer.

Professor Hughes Hallett: Without knowing exactly how far it has gone, we are aware that the Scottish Government people are working on getting some behavioural responses into the non-domestic rates bit. We are watching that and we will perhaps go through the process with the Scottish Government step by step to see what we can say before we get to the next report. The same should apply elsewhere, but the work is probably not as advanced at the moment.

Gavin Brown: I will move on to non-domestic rates. I think that your view as a group was that the buoyancy increase for business rates growth was on the optimistic side—I think that you used that term. The Government has reduced its forecast slightly on the back of that. Can you talk me through what happened there? Did you say, “We think it’s optimistic by X per cent and we think you should do this” or did you simply use the term

“optimistic side” and the Government then did the work? It would be useful to know what happened.

Professor Leith: We looked at the Government’s approach to forecasting. I think it has eight years of data showing the historical average for growth and buoyancy over that period, as well as a range of macroeconomic and microeconomic indicators, which it uses to try to suggest whether the economy will grow faster or slower than in previous years. It looked at those indicators, took a reasonably optimistic view of them and then went to the upper level of the historical bands that we had observed for buoyancy. Perhaps it was correct to take an optimistic view of the economic conditions going forward, but, in relation to the impact on buoyancy, it was going to the upper limit of what had been observed in the past. We pointed out that that seemed to be at the upper limit of anything that we had seen in the limited data that we have and said that it appeared optimistic. We said that the view might be reasonable, but it seemed on the optimistic side. The Scottish Government adjusted its forecasts on the basis of that, but we did not tell it what adjustment to make.

Lady Rice: It is not our job to do that.

Gavin Brown: My last question is on business rates, which ties in with the previous question. There are previous years’ data to look at. For next year could you look at the estimates and projections for business rates? We have 10 or 15 years’ worth of data for that. Could you look at the original estimates versus the outturn and what the estimates were based on? Could work be done on that to see how we can improve the model going forward?

Professor Leith: Yes. For all taxes we would seek to look at forecasts and outcomes. The more information we have on that, the more we can inform improvements in modelling.

Professor Hughes Hallett: It is a difficult thing to do, because you want to look at the differences and then ask why they happened. It is a cheap point to say that what happened in this case tells you that the inquiry and challenge approach is effective—that has happened on several points. Considering how much of an allowance you would want to make in the future is much more judgmental.

Professor Leith: Yes, but part of our job is to make a judgment and we do that better and better the more data and evidence we have, so Gavin Brown has made a good suggestion.

Gavin Brown: I am grateful. Thank you.

Malcolm Chisholm (Edinburgh Northern and Leith) (Lab): Does the Scottish Fiscal

Commission have any input into or involvement with the Smith commission?

10:30

Lady Rice: I will explain exactly the involvement. I wrote to Lord Smith a little while after his appointment was announced and wished him well in a challenging task; I know him, so it was fairly easy to say it in these words. I said, “I just want to remind you that the new Scottish Fiscal Commission exists.”

We do not intend to make a submission to the Smith commission because that is not our role. On the other hand, if the commission comes to us at any point to share an idea, try something out or ask us questions, we would respond, but only within our remit. We are very conscious of our remit and we are conscious not to stray. That seemed to be the appropriate way to engage with the Smith commission. I would appreciate any guidance on that.

Malcolm Chisholm: In your other roles, will some of you make submissions to the Smith commission?

Lady Rice: There is a non-incorporated body called the 2020 climate group, which is a group of volunteers from business, Government and others who are trying to influence the momentum on the climate change agenda. It may possibly make a statement to the Smith commission, but it has not done so yet. My thinking was that I could be excluded, but it is not even a real body, in the sense that it is a non-organisation—it is a group of volunteers.

Looking at my other engagements, I have a very big involvement in the festivals forum, as I chair the board that looks after the strategic positioning of the city of Edinburgh and all the festivals. The board has not made a submission. If that was discussed, I would think about any relationship to the Fiscal Commission and would not necessarily put my name to something. I am not aware of any other inputs that would cross over my worlds.

Professor Hughes Hallett: My answer is exactly the same. The Fiscal Commission does not do policy advocacy, so it could not make a submission. If the Smith commission came to us, we could say something, although it is a bit difficult to say what that might be.

Lady Rice: If the Smith commission approached us, we would see on what basis it did so. It may not approach us; why would it, in a sense, given what we are responsible for? However, if it did, we would discuss whether and how we could respond.

Professor Leith: I have colleagues at the University of Glasgow who are making written

submissions to the Smith commission. I was asked to be involved but declined, given my position on the Fiscal Commission.

Malcolm Chisholm: Okay. Thank you.

Jean Urquhart (Highlands and Islands) (Ind): I return to the data—the missing data, if you like. When you looked at the systems that the OBR employs, did you find them really impressive? Did you get excited about the detail in the data collection that it has to make its forecast?

Professor Leith: The OBR has access to the full set of Office for National Statistics and Treasury data that is needed to run multihundred equation models, so it has a large set of data on which to base its forecast.

Jean Urquhart: Has its forecasting with such data always been impressive? My experience on this committee is not great, but the OBR has often been fairly spectacularly wrong in its forecasting.

Professor Leith: The OBR's approach is to build a very large macroeconomic model. The academic literature performs horse races between alternative approaches to forecasting and puts that style of macroeconomic model against relatively simple statistical models. Over a short-term horizon, short-term statistical models often outperform large-scale macroeconomic models, but the OBR needs to produce a set of forecasts for a huge number of variables and it needs to be coherent and consistent. It needs a big model to perform that task, so there are trade-offs.

Lady Rice: It might be worth noting that we have exactly that kind of debate among ourselves about whether one type of approach—the big model or the simpler approach—is better. The simpler approach that is being taken here out of necessity also felt quite comfortable and helped us to come to the conclusion that the results were reasonable.

Jean Urquhart: On the collection of that data, do you foresee yourself engaging with other institutions such as universities, which often do quite detailed research in some of the areas that would be relevant to you?

Lady Rice: Yes. We spoke about that at the beginning and we probably know some of the universities that gather up a fair amount of data. Again, we have reached out a little bit, and part of our follow-up programme is considering the bodies that we might have relationships with. We might also want to commission some research at some point, for which we would be likely to turn to a university because its work would be impartial and independent and would have the integrity of academic research.

Professor Hughes Hallett: I can think of several universities or institutes that do such

research, but it is usually done on one bit of the economy. I can think of one example that focused on the labour market, so we could look at the important factors in that area to see whether they affect the forecasts that we are looking at. However, I am not sure that we will find very much research on the Scottish economy per se—perhaps such work should be done. I can think of one example but, having been into it, I would not use that model. The research is patchy.

Jean Urquhart: In general, you are saying that the focus of the work in some of the areas that you are looking at is almost microscopic compared with that of the OBR, but the chances are that it could be much more exact.

Lady Rice: Do you mean the smaller models?

Jean Urquhart: Yes.

Lady Rice: There is a chance that that could be the case, but part of that could be about the data collection and the integrity of the data as it is stored and reported. The biggest issue lies in getting genuinely Scottish-specific data. That is important and it would help hugely when it comes to quality and the assurance that we feel towards the forecasts. We see the way forward, what is intended and what has started here. That is an important place to be.

Meeting fiscal commissions from elsewhere would allow us to chat about the kind of question that Jean Urquhart raised with somebody completely outside our ambit in order to get a little bit of their experience and learn what they have found useful. It is a good question.

Jean Urquhart: Thank you.

The Convener: That concludes questions from the committee. Would the witnesses like to make any further points?

Lady Rice: Do you have anything, Andrew?

Professor Hughes Hallett: No, I think that we have covered everything.

Lady Rice: I just want to thank you, because you have obviously gone into the report in some detail. I am a note-taker and I have noted a number of the committee's questions. I will make sure that they come up on our agendas for discussion. We appreciate that.

The Convener: Thank you very much for the evidence that you have given to the committee.

I suspend the meeting until 10.45 to allow a changeover of witnesses and to give members a natural break.

10:38

Meeting suspended.

10:47

On resuming—

Further Fiscal Devolution

The Convener: Our next item of business is evidence for our inquiry into proposals for further fiscal devolution. I welcome to the meeting Professor Iain McLean. Members have copies of Professor McLean's written submission. We will go straight to questions from the committee. As is the fashion on this committee, I will start off and, once I have asked some opening questions, I will open up the session to colleagues around the table.

Your paper is a short but interesting one, Professor McLean. I am sure that it has given members of the committee plenty of food for thought. You list what, in your view, should and should not be devolved, but there are one or two areas in which you have caveats, and I want to explore them with you. For example, you say:

"The rest of income tax could be devolved".

Should it be devolved?

Professor Iain McLean (University of Oxford): I think that the issue makes less difference than most of the parties in the debate, on both sides, do.

As I say in my paper, what is really important is the marginal taxation principle that, at the margin, you and your colleagues have to decide between taxing and spending. You already have that ability under Calman—under the Scotland Act 2012—and it is not clear to me how much extra you would get by having the whole of income tax devolved.

Nevertheless, it would be possible to devolve the whole of income tax, although it would need to be made clear what was meant by "devolve". If it meant devolving the right to set the bands and even who was required to pay income tax, devolving the whole of income tax would be a big deal. However, if the bands, exemptions and so on remained uniform at a UK level, it would not be a big deal.

The Convener: Do you believe that Scotland should control the size of bands, who qualifies and so on?

Professor McLean: I can see arguments both ways. Given the way the referendum vote went, Scotland remains in the UK. That means that, although having the power to set rates and bands would give this Parliament a lot more autonomy and responsibility, there would be pretty heavy transaction costs, beginning with defining not only people but sources of income as either Scottish or non-Scottish. I am perhaps torn at this point between head and heart—I am not sure which is

which. At any rate, the principle of maximum autonomy means devolving control over rates and bands, but practical considerations suggest that that would be really quite difficult.

The Convener: Your view differs from that of the former Prime Minister, Gordon Brown, in terms of the impact that it would have on MPs in the UK. Your submission says:

"MPs would remain responsible for the overall UK tax structure and for macroeconomic management".

Is that the case?

Professor McLean: Former Prime Minister Brown will have to speak for himself. As I set out in my note, my view is that, since the Westminster Parliament would remain responsible for, at an absolute minimum, the rates and bands in the rest of the UK and for those taxes that cannot be devolved, there would seem to be a role for Scottish MPs in Westminster in all circumstances, even if the whole of income tax in Scotland were to be devolved.

The Convener: You have said that North Sea oil

"should be the first candidate for further tax devolution."

Could you expand on your rationale for that? You also say that you do not think that corporation tax should be devolved. Do you think that the revenue that is raised from corporation tax vis-à-vis North Sea oil should be?

Professor McLean: There are three issues here. The first concerns what economists call the economic rent that is derived from North Sea oil, which is possibly captured by taxes other than corporation tax. Secondly, there is corporation tax on North Sea oil. Thirdly, there is the rest of corporation tax.

From my note, members will have noticed that I am an avid disciple of Adam Smith, and I am honoured to be speaking a quarter of a mile from Panmure house, where he wrote "The Wealth of Nations". I am pleased that the Cabinet Secretary for Finance, Employment and Sustainable Growth feels that it is right to start from Adam Smith's principles. Smith argues that rents are the most appropriate subject for taxation—in a modern context, I would say taxation at a devolved level. The pure principle of tax policy, as laid out by Adam Smith and his successors, especially David Ricardo, leads me to suggest that rents from the North Sea should be the next tax base that the Parliament should control.

There are three easy reasons why I say that, within a continuing union, corporation tax should not be devolved: Amazon, Starbucks and Google. All members will have seen the performance of representatives of those companies before the

Westminster Public Accounts Committee. Given an opportunity to avoid tax, multinational corporations will do so. Given that that is the case, if a Parliament such as this one—I know that Northern Ireland is asking for the same power—were to take control of corporation tax levels, there might be some gain in terms of the revenue that is received by this Parliament but, as sure as eggs are eggs, there would be a loss to the revenue that is received from corporation tax in the UK. As my note says, I therefore do not think that, within a continuing union, corporation tax should in general be devolved.

Corporation tax on North Sea operations is a slightly different matter, because North Sea oil is where it is—you cannot pretend that it is in Luxembourg. Therefore, devolving the whole of North Sea tax is perfectly feasible, as well as being desirable on the grounds that Adam Smith set out.

The Convener: Thank you. I am really impressed by your clear, concise answers. I do like that, I must say. [*Laughter.*] I do not always agree with them, of course, and I am sure that members will have their own views, too.

Another area where you talk about assignment—I am trying to tease out a direct answer on this one, too—is VAT. You say:

“the proceeds of VAT in Scotland could be assigned”.

Do you believe that VAT revenues should be assigned to Scotland?

Professor McLean: I see no reason why they should not be assigned if the result of the Smith commission, which is the context in which we are all talking, were to be some form of devo max. That could involve the assignment of VAT revenues. It would give this Parliament some limited control, but it would only be limited, because you would not control the rate or the base of VAT. You could, say, encourage retail developments in Scotland so that people spent more, if you and colleagues thought that that was the policy desideratum.

However, I think that it is more a matter of giving the Parliament revenue consistent with its spending responsibilities in order to reduce the vertical fiscal imbalance—VFI—that I open my submission by talking about.

The Convener: Indeed. At the back of your submission, you give us some interesting statistical information on various countries in relation to that.

I have a final question before I open up the discussion to colleagues round the table. In talking about what taxes should be excluded, you mention capital gains tax, income tax on savings and

inheritance tax. Will you give us your thoughts on those three taxes?

Professor McLean: Yes. The reasons are more practical than principled. Members will know that there has been a lot of discussion particularly within HMRC but also between it and the UK Government and, I am sure, the Scottish Government, and the sheer physical difficulty of identifying a Scottish source of income seems to HMRC to be an insuperable objection to the devolution of income tax from savings and investments. It is not for me to say whether it really is such an objection. I expect that you have it in mind to interview officials of HMRC, and I think that it would be a question to ask them rather than me.

Maybe the cases are different and I should have written more carefully. My reason for not recommending devolution of capital gains tax is that it is a tax on capital, which can move around. As soon as the rate varied, you would see all sorts of schemes whereby companies would incorporate in Scotland and the issue that I raised with corporation tax would come up again. To speak frankly, I think that you would get pretend incorporations in whichever jurisdiction had a lower tax rate.

Given that most of what is caught by inheritance tax is property, which is where it is—it is fixed—there might, on second thoughts, be a case for devolving inheritance tax. Of course, there could be a policy issue. If this Parliament wanted to take a different line from the Parliament at Westminster as to the rate and base of inheritance tax and particularly whether the threshold should be raised, I might say “go for it”—on second thoughts, and contradicting what I say in my submission.

The Convener: Excellent. I am glad to hear it.

Sorry—I am going to hand over to my colleagues, but I meant to ask for your view on the devolution of air passenger duty, which has been in the news quite a lot in the past 24 hours.

Professor McLean: Yes, I am aware of that. For the noise that has been made about what is an extremely small tax—see my table 2—I am surprised that so much fuss is made about it in either direction.

My overriding comment is that APD is so small that people should be rather wary about listening to the vested interests. You and the public have been lobbied by airlines that would like to pay less tax. Well, that is hardly a surprise.

Airports are where they are, and therefore APD comes under the Smithian principle of taxing the least mobile base. Given the configuration of airports in the UK, I do not think that there are any huge policy issues. The Scottish Government has

already said—in its white paper, I think—that it would like to reduce the rate of APD that is paid at Highlands and Islands airports, and I can see obvious policy sense in that.

Competition between Scotland and England is not a huge issue. It is 100 miles from Newcastle airport to Edinburgh airport, so it would not be a matter of severe competition between adjacent airports were the rate of APD to differ. Therefore, with all deference to the lobbyists who have been lobbying hard on the issue, I do not think that it is a particularly big issue either way.

11:00

The Convener: Thank you. Colleagues round the table will now ask questions.

Malcolm Chisholm: The assignment of VAT and possibly corporation tax would obviously have the advantage of increasing the proportion of our budget that we raise, but would there be any economic or other advantages or disadvantages from assignment?

Professor McLean: It is hard to see any real advantages—you just get the revenue. VAT is a really big tax, so the revenue income is important to budgeting. However, do you have the policy tools that would allow you to change people's behaviour in relation to expenditure? You might want to do that, but I think that you would want to change the coverage and the rates, and that cannot be done within an EU member state, as my written submission says. Therefore, I do not see any huge advantages from assignment, other than the one that I mentioned in my previous answer, which is that it gives you control over a higher proportion of the tax revenue that accrues in Scotland.

Malcolm Chisholm: My next question follows on from that in a way. One problem with assigning VAT is about what would happen in a recession but, moving on to oil, the problem is not just in a recession. There would be a loss of revenues in a recession, but even under other circumstances the price of oil fluctuates considerably, as has happened this year. How would we deal with that problem? This year is a good example, because I think that oil revenue is a lot lower than the Scottish Government or the OBR anticipated. Obviously, if that was part of our revenue, it would be a significant part of the Scottish budget.

Professor McLean: I start with what the people of Scotland want. As my written submission says, it is well established from surveys that the people of Scotland want this Parliament to control all domestic public spending. For the reasons that I set out at the start of my submission on VFI, I do not think that it is responsible for this Parliament to control spending if it does not also control taxing.

That leads me to say, for the reasons that I gave earlier, that North Sea revenues are a suitable subject for devolution and VAT is a suitable subject for assignment. If that brings the set of issues that you raise that North Sea oil is volatile and VAT is volatile in a downturn—it is one of the least volatile taxes, but it is volatile in a downturn—all that I can say is that the Scottish people should beware of what they wish for. They wish for maximum devolution, and that is the consequence of maximum devolution. If they did not want devolution, they could be protected from fluctuations in oil production. However, it seems that they want devo max.

Malcolm Chisholm: In terms of powers for this Parliament, is it the implication that we would have to have significant borrowing powers to cover such shortfalls, or would that bring economic problems to do with issues such as interest rates or what is feasible for UK macroeconomic management?

Professor McLean: When I gave evidence to the committee previously, I recall saying that I am a borrowing powers fundamentalist. I was maybe telling some tales out of school from the Calman independent expert group, of which I was a member and with which members will be familiar.

My view, although it was not the view taken ultimately by the IEG or by Calman, was that market discipline is the control that really works and that this Parliament should have borrowing powers. Of course, borrowing powers to cover fluctuations are one thing; borrowing in order to fund current expenditure is quite another and should not be done. Were this Parliament to do it, the markets would notice very quickly and impose penal rates. However, I am all in favour of borrowing to cover fluctuations.

Malcolm Chisholm: You have used the term “devo max” quite a lot, and it featured very prominently in our debate yesterday, including in my speech. You obviously want to exclude certain taxes, so what do you mean by devo max?

Professor McLean: Sorry—I was just using the popular phrase. It has been very widely undefined, if I may put it that way. Practical devo max for me would be the devolution of the list of taxes that I have set out in my submission, with the possible addition, on second thoughts, of inheritance tax.

Malcolm Chisholm: So devo max is what you define it as.

Professor McLean: No. If a policy maker came to me and said, “I want devo max”, I, as an academic, can only say, “What do you mean by devo max?” Then I would say, “This is a good idea, or a bad idea, or a good idea up to a point, because here is how Adam Smith's principles of taxation apply to your proposal.”

Malcolm Chisholm: This is my last question. Because you have given such clear and concise answers, we have a problem in coming back to you because you have already given your view so clearly and concisely.

As you have suggested, perhaps the income tax issue will dominate to an unnecessary or undesirable extent. Gordon Brown has raised the stakes on the issue, and every party seems to have a different view on it. I am probably asking you to repeat yourself, but I am genuinely interested in the issue. Professor Ronald MacDonald will probably have things to say about it next week, although we have not seen his submission.

On what Labour is proposing on income tax, I suppose that Gordon Brown has looked at it in terms of the implications at Westminster. In a way, you have touched on that. Can you think of any other economic reasons why it might be desirable to withhold some parts of income tax? Gavin McCrone suggests in his book that there could be quite good economic reasons for keeping some parts of income tax. I cannot remember his detailed arguments; I think that they were to do with emergencies arising and needing to have some income tax powers at UK level. I may be paraphrasing him wrongly.

Do you think that there are any sound economic arguments for dividing income tax in that way, or do you think that, at the end of the day, it is down to a judgment about the consequences of it for the position of Scottish MPs at Westminster?

Professor McLean: I think that it is primarily the latter. I did not dwell on that point because it seemed not to be germane to my evidence to this committee. If asked to give evidence to William Hague's committee, which I have not been, I would talk about that at considerable length—or at whatever length seemed appropriate.

As to the economic advantages of holding back some proportion of income tax, I confess that I have not read Gavin McCrone's new book. I should have done and I wish that I had. He is very well able and qualified to speak for himself, and I hope that the committee will consider asking him to give evidence, if it has not done so already. I would guess that the sorts of reasons that he and others who make this point have in mind are reasons to do with sudden shocks. After all, a sudden plunge in the oil price might be the most likely shock that Scotland could be exposed to.

Sudden shocks can be damped within a union by redistribution. Redistribution is difficult if this Parliament controls almost every tax and every tax base. That takes me back to repeating myself that the Scottish people should beware of what they wish for, but we know what the Scottish people

wish for. Maybe this Parliament should say, "Careful, people of Scotland, because devolving the maximum amount of tax possible means less room for cushioning shocks."

Malcolm Chisholm: To summarise what you were saying on the specific issue of the effect at Westminster of devolving income tax entirely to this Parliament, is it your view that the devolution of income tax would not in itself make any significant difference, whatever the pros and cons of different arguments about the position of Scottish MPs at Westminster?

Professor McLean: For sure it will make a difference. It might raise questions about the number of Scottish MPs at Westminster, and that is not a matter for me as a witness to the committee, nor for this Parliament, although I can see that it could be an issue.

The nitty-gritty will be around the question of whether devolution of income tax means devolving control over rates and bases, and that cuts both ways. If the rates and bases are not devolved, there really does have to be a Scottish presence at Westminster, because there are lots of highly political questions about controlling the level of the personal allowance or deciding whether there should be a 50p top rate. If I were living in Scotland, I would want to be represented by an MP who could help to make my views on those matters known.

If, on the other hand, the devolution was so extensive that this Parliament had the power to set different rates and bases to those applying in England, it would bring up a classic West Lothian question about whether Scottish MPs would be allowed or advised to vote on English rates and bases. However, even in that case, if the level of personal allowance was set in England, it would quite severely constrain the freedom of this Parliament to set a different rate of personal allowance, to avoid gaming behaviour. As we all know, in matters of income tax it is the rich who are in the best position to game; people will suddenly turn out to have a house in Scotland if it benefits their tax position, or in England if that works better.

Members will be aware that I am thinking on my feet, but I think that in either case there remains an argument for having Scottish MPs in Westminster.

Jamie Hepburn: I return to the issue that the convener raised about the part of Professor McLean's paper in which he suggests that control of North Sea oil should be the first candidate for further tax devolution. That tallies with evidence given by the Chartered Institute of Taxation and by chartered accountants in England and Wales to the Treasury Select Committee yesterday. My

question is not meant facetiously; it is quite genuine. I presume that you do not literally mean the North Sea, but that we should control taxation of resources that are within Scottish jurisdiction.

Professor McLean: I did mean that, yes. I apologise for the shorthand.

Jamie Hepburn: That is okay, but it does beget a more serious question. Control of tax is all well and good, but should we also control the licensing regime for the extraction of such resources?

Professor McLean: It would make sense for the one to go with the other; as part of the overriding picture, tax and spend responsibilities should go together. In practice, it would be hard to unwind any promises given by the UK Government to companies exploring in the North Sea.

Jamie Hepburn: Or elsewhere.

Professor McLean: I beg your pardon.

Jamie Hepburn: Or elsewhere.

Professor McLean: Yes, indeed. West of Shetland, or wherever, the same issues apply.

Should this Parliament want to give new incentives to encourage exploration—I do not know whether that was behind the question—I would be fine with that. Of course, new incentives mean less tax receipts, at least in the short run.

Jamie Hepburn: I was also thinking that there might be areas that the UK Government has decided should not thus far be utilised. The Scottish Government might take the view that they should continue not to be utilised, or it might decide that they should be. I am thinking specifically about the basis on which extraction of resources is currently licensed; perhaps the Scottish Parliament would say that we do not want to decide on those arrangements, or perhaps we would say that we do. Apparently, there are deposits in the Firth of Clyde that have not been utilised. We might decide that that is okay, or we might decide that actually we would like to utilise them.

11:15

Professor McLean: I am out of my comfort zone, colleagues, because that gets into the nitty-gritty of oil taxation. Although I do not know the answer, I know a man who does: Professor Kemp of the University of Aberdeen, who is well known to all of you, would be the right person to pose such questions to.

I would be surprised if there is any source in relation to which there has been a policy decision, by any Government, not to exploit, but I am outside my area of knowledge.

Jamie Hepburn: Okay—that is fair enough.

I turn to VAT. This might be a moot point but, if there were not a restriction on setting differential VAT rates within an EU member state, would you recommend that that should be devolved?

Professor McLean: If there were not a restriction, the issues with VAT would become the same as those with excise tax on tobacco, alcohol, petrol and so on. I do not mention those issues in my submission, although I mention them in other stuff that I have written. Although the issue is mitigated by the thinly populated border between Scotland and England, even if rates vary by only a penny or two, some people will drive 100 miles from Glasgow to Carlisle or 150 miles from Manchester to Gretna to profit from the lower rate.

From one perspective, that is all very fine. If this Parliament is the one to gain the revenue from having a lower excise, say, it might not worry too much about the fact that tax receipts in the UK as a whole have gone down.

I accept that this is about excises more than it is about taxation, but it would be more difficult were the Parliament to levy higher excise on behaviour that it would like to curtail, such as smoking, drinking or driving too much. Instead of there being an enormous hypermarket at Gretna, there would be an enormous hypermarket at Carlisle, and people would drive from Glasgow to take advantage of the lower rates.

Were VAT allowed to vary, the same sort of thing would apply times five or 10, because VAT is five or 10 times bigger than excises.

Jamie Hepburn: It is all hypothetical anyway.

On the idea of assignment, I suppose that the rationale is that the Scottish Parliament or the Scottish Government could try to influence behaviour that could increase revenue. How effectively equipped are we to do that?

Professor McLean: We have to be very pedantic here. The Parliament may increase rates, which may or may not increase revenue. I am aware of discussion about imposing a minimum unit price on alcohol or other devices to encourage prosocial behaviour. It is a fact about the world that the Parliament's power to control behaviour by such means is not unlimited, because people will go somewhere where the tax rate is less to get their spirits and cigarettes. That is a fact about the world, which the Parliament cannot really do anything about.

Jamie Hepburn: If VAT revenue were assigned, should the Parliament and the Scottish Government have some form of statutory right to be consulted on the rate, albeit that they would not be responsible for setting it?

Professor McLean: That might be a sensible thing to ask for, yes.

Jamie Hepburn: That was a very concise answer—thank you for it.

Still on the implications of further financial powers and the role of Revenue Scotland, you suggest that it could make sense for other taxes to continue to be collected by HMRC. Is there not a slight concern that HMRC is not within the legislative competence of the Parliament? If we had taxes that we were responsible for legislating for but we could not legislate for HMRC, would there not be a slight concern there, or would you suggest that HMRC should become a shared legislative competence? There might be difficulties there. Would it not be easier to go back to what I think everyone has thought would happen: that the role of Revenue Scotland should be enhanced to deal with the further devolution of taxes?

Professor McLean: My answer on that was driven only by what academics call barefoot empiricism—I looked for Revenue Scotland's website and found that it is not there yet. If it does not even have a website yet and it has a few hundred million pounds of taxes coming its way very soon, I do not think that it is quite ready to deal with £10 billion of income tax receipts. Therefore, my suggestion is a purely practical one.

Agency agreements between HMRC and Revenue Scotland would be very easy to reach. I would not think that they would require parliamentary authority but, if they did, the Sewel motion procedure would be very easy to apply.

Jamie Hepburn: As a committee, we have a scrutiny role and we would probably find it easier to scrutinise Revenue Scotland, which, after all, is a creature of statute of the Scottish Parliament, than HMRC, which is not. It is interesting that you could be taken as saying that the answer is that we just need to enhance the responsibility of Revenue Scotland. Is that still a possibility?

Professor McLean: That is up to this Parliament. The normal presumption would be that the Parliament that levies a tax also collects it, but—I say this without taking any position on the union—there are economies of scale in tax collection, most especially for the big ones: income tax, national insurance and VAT.

Michael McMahon: I wonder whether you could help me to get a better understanding of the technicalities of the block grant adjustment. Under the Calman proposals and the Scotland Act 2012, two taxes have come to Scotland. That has been very uncontroversial, because the taxes in question are not very big and are limited in scope. However, the devil has been in the detail. It has been extremely difficult to get the block grant adjustment agreed, and the Cabinet Secretary for

Finance, Employment and Sustainable Growth has made us aware of his frustration about that.

If responsibility for more taxes were to come to Scotland, which would involve more adjustments, how much more technical would the process become? How problematic would that be? Would we have to have a standard adjustment for all the taxes, or would each tax that was transferred to Scotland require a different set of adjustments?

Professor McLean: That speaks to one of the frustrations that I know that many people have, which is that, currently, how the Barnett formula works is entirely in the hands of HM Treasury; it is not a statutory matter. If the Scottish Parliament or the Scottish Government does not like what HM Treasury is doing, there are—to my knowledge—no mechanisms to pursue that, except perhaps the joint ministerial committee.

Therefore, I would prefer there to be some neutral ring holder. I have written about that elsewhere, and I commend to the committee the example of the Commonwealth Grants Commission in Australia, which is not controlled by what is called the Commonwealth Government or by the states, although it is licensed by all nine of those bodies to make allocations. If the future of the block grant remains in question, it would be desirable for it to be controlled by a public body of some sort that was not an agency of one of the parties to the argument—in other words, a body that was brought under the joint control of, say, the Scottish, Northern Irish, Welsh and UK Parliaments. I can foresee that very quickly the question would emerge whether each of the Parliaments would have an equal number of votes or whether the UK Parliament would have more votes than the others, and I do not have an immediate answer to that question.

Michael McMahon: We have considered the Welsh Assembly's perspective on Barnett. Do you have sympathy with its position?

Professor McLean: I have sympathy with its position as regards Wales, which is very clear. Its position is that Wales does disproportionately badly out of Barnett, given how poor Wales is. The Welsh Assembly has made it quite clear that it would prefer a needs-based assessment.

As members will know, that issue was aired during the Calman process. The Commission on Scottish Devolution and the independent expert group that advised it did not say that they wanted a needs-based assessment to replace Barnett. As everyone in the room knows, on the basis of a plausible needs-based assessment, Scotland's block grant would be less than it is under the present arrangement.

Michael McMahon: Do you think that if we continue down this road it is still conceivable for

Barnett to remain unchanged? Can people who argue for devo max also, with any justification, ring alarm bells about its implications for Barnett?

Professor McLean: There are two almost balanced fallacies on opposite sides. First, there is the fallacy made by people who—and I am not going to be partisan here—appear in Scotland very shortly before a referendum to make a vow that contains two inconsistent promises: first, that this Parliament's fiscal autonomy will be increased; and secondly, that Barnett will be protected. At some level, those promises are incompatible, and you would need to interrogate the people who made that vow to find out which one they really meant. On the other hand, and to be fair in my condemnation all round, I think that it is inconsistent to demand maximum possible devolution of taxation, including taxation of, for instance, North Sea oil receipts, while asking for protection from the consequences of that devolution by having Barnett-type transfers.

Michael McMahon: That is a fair answer. Thank you very much.

John Mason: I want to pursue something that I do not think has been mentioned so far. In a bullet point in the executive summary to your submission, you refer to “unfavourable demographics” in the event of Scotland wanting to have full control over social protection. What do you mean by that phrase?

Professor McLean: I mean the unfavourable post-65 demographics that have been much discussed over the past six months. The pension-age population as a proportion of the overall population is somewhat higher in Scotland, and the projections are somewhat less favourable for Scotland than for the UK as a whole. I also note that morbidity and chronic disease are worse in Scotland. They are similar policy issues; however, you can do something about disease in Scotland, but you cannot do anything—at least in the short term—about the age structure of the Scottish population. If you take on responsibility for social protection, you take on at the margin the responsibility for finding the money to pay for it. That is a policy choice, and it is not for the likes of me to say whether the Parliament should make it.

John Mason: So are we saying that at the moment Scotland spends proportionately less on social protection than the rest of the UK but that in future there is a risk of that switching?

Professor McLean: No, I am not saying that exactly. As you all know, social protection is predominantly reserved, which means that the risk—or, if you will, the shock—of Scotland's having an older population and a population in worse health is absorbed at UK level. If the

function is devolved, Scotland will have to meet all of that out of its own resources.

John Mason: Presumably, though, it could work both ways. Generally our people are dying earlier—certainly my constituents are—and there is a risk that if they lived longer it would cost us more. On the other hand, there is also extreme ill health, and there is the opportunity to improve that situation and benefit from that. Can arguments not be made on both sides?

Professor McLean: Oh, yes. I do not think that any politician is going to say, “Come to Scotland and die earlier,” but I realise that that is not the point that you are making.

John Mason: You have only to travel on a railway line through Glasgow and you die earlier.

You are in favour of devolving control of North Sea oil, because it is linked to the issue of rent, which I will come back to in a moment. The usual argument against that is volatility, but I presume, again, that volatility can work both ways. If the projections for future oil revenues are lower, we might gain more from having the revenues, but if the agreed projections were higher, there is a risk that we would lose out. Again, it could work either way and it would really depend on how the adjustment was made.

11:30

Professor McLean: It certainly could work either way. If North Sea oil receipts were devolved and went up, this Parliament and the people of Scotland would be in a good place. I do not think that there would be any question of adjustment, but we would have to see what formula succeeded Barnett. If any such formula were based on needs, an upsurge in oil revenue would be, on the face of it, irrelevant. Also, formula funding would become a very small part of the finance available to this Parliament were there to be any form of devo max—as defined not by me but by the politicians who agreed what it meant, perhaps at the end of the Smith process.

John Mason: I am interested in your argument, based on Adam Smith, that the rent side is the one that we should emphasise. In this paper and elsewhere, we have tended to look at existing taxes and who controls them. We have perhaps not looked so much at possible new taxes.

First, would you argue that we should move all taxes towards the rent end? Something like land value tax has been suggested over the years. Is that something that we could or should be able to introduce in Scotland rather than just moving around existing taxes?

Professor McLean: I am laughing slightly because to be in favour of land value tax is taken

as a sign of madness in some quarters. In fact, the arguments for land value tax are perfectly sane and were made by Adam Smith and by David Ricardo. Land value tax has been taken over by some people who might be regarded as rather cranky but the underlying arguments are good.

Were this Parliament to move towards a land value tax, I assume that it would be substituting that for council tax and business rates, which are the existing taxes on land and property. Speaking only as somebody who is interested in tax structure, I would be delighted if this Parliament did that because I think that the underlying economic arguments for a land value tax are sound. The Parliament has already come under immense pressure from interests and lobbyists in this area but I am a huge fan of the work of Andy Wightman in this area, which will be known to all of you. I suggest that you ask him about that matter.

John Mason: You have given us a lot of suggestions for future witnesses, I have to say.

You said that if there is more devolution, there is less room for cushioning the shocks. I guess that that would be true if the shock was external to the UK but if it was an internal shock coming from Westminster, presumably more devolution would give more room for cushioning?

Professor McLean: You are thinking of tax policies?

John Mason: Welfare reform—cuts to welfare.

Professor McLean: Okay—so you are thinking about the currently controversial bedroom tax and so on. It is true that there would be more room for cushioning if this Parliament decided that it did not want to implement a welfare tax that it did not like. Of course, if that resulted in less revenue, it would have to find the revenue somewhere else or adjust spending policies. However, that is the whole point of being a fiscally responsible Parliament, which is what underlies all my remarks.

John Mason: Finally, HMRC and Revenue Scotland have already been mentioned. When we put out the bids for the previous taxes, it seemed that we could do it more cheaply than HMRC could. That makes me wonder whether there would be an option to simplify the tax system, although you said that there are economies of scale. If we could have control of all income tax and national insurance, we could put the two together and have a simpler system that might actually cost less to run.

Professor McLean: That is possible, because it is easier to run a tax system in a country of 5 million than in a country of 60 million. On the other hand, we are in the notorious territory of computer systems, Government and big information

technology failures. My note of caution is that big IT failures are perfectly possible in a country of 5 million—we all know that they are possible in a country of 60 million. The option is worth exploring, but I would not put my shirt on it.

John Mason: LBTT is, in effect, a completely new tax, and Revenue Scotland will be starting with it. If it was income tax, we would be starting from where we are. Presumably, one option—rather than just transferring everything to Revenue Scotland—is to split HMRC and to take a chunk of HMRC, which would look after income tax, for example, and that would become whatever we called it in Scotland. Is that an option?

Professor McLean: You should take advice from the revenue authorities. My understanding is that that already happens, given that HMRC organises its tax-raising function by tax rather than by region. Some people collect income tax and others collect stamp duty land tax, and so on.

I do not want to detain the committee with details, but I believe that the arrangement goes all the way back to Robert Peel in 1842, when income tax was introduced, and before that to William Pitt in 1799, I think. He wanted to ensure that there was a different administration for each tax on the principle, in those days, that a gentleman should not be interrogated by a tax collector on the whole set of his income.

I think—although you should take evidence from the tax authorities—that HMRC is already organised functionally rather than regionally.

Gavin Brown: Professor McLean, can you briefly talk us through table 1 in your submission? It refers to the vertical fiscal imbalance, which I believe is one of the priorities that you want to deal with. I want to get my head round the figures. The UK figures, which are helpfully in red—at least in my copy—are 36.4 per cent for central revenue and 4.2 per cent for subnational revenue. For Spain, in the line above that, the figures are 22.7 per cent and 12.2 per cent respectively. However, the vertical fiscal imbalance figures for Spain and the UK are fairly similar. Can you talk us through the way in which those figures come out?

Professor McLean: Yes, with pleasure. There are different ways of measuring VFI—for this purpose, I used the simplest possible method, which is in effect to subtract column 2 from column 4. For the UK that is 14.5 per cent minus 4.2 per cent, which gives 10.3 per cent. In the row above, for Spain, it is 22.6 per cent minus 12.2 per cent, which rounds up—there is a slight rounding error there—to 10.5 per cent.

One problem with regard to the year from which those data were taken—I took that year, 2009, because I was working in connection with Calman at the time—was the depth of the financial crisis in

all OECD states. You will notice that, in every single case, spending exceeds revenue. Every country in the table was in deficit in that particular year. However, that does not affect the general principle that one way to measure VFI is simply to calculate the difference. There are more complicated ways, but I went for the simplest.

What drives the relatively high UK figure is the fact that subnational revenue is such a low proportion of revenue collection. In the UK, essentially only council tax and business rates are levied by bodies lower than the UK Parliament. That is changing in Scotland, but Scotland is only 10 per cent of the UK, and the changes that we have discussed in this session would not in themselves change the number all that much.

Gavin Brown: That is helpful—I am grateful for that answer.

I will pick up on one or two other small points. In your paper you mentioned some of the areas that you would not devolve, and you gave explanations for all those areas except for inheritance tax. Given what you have said today, you might have a slightly different view. However, for the sake of completeness, what was your initial reason for saying that inheritance tax would not be a candidate for devolution?

Professor McLean: I was once again applying the pure gospel of Adam Smith and saying that inheritance tax is a tax on capital. My reason for changing my mind in real time while sitting before the committee is that the assets that a person who has died typically owns consist mostly of a house. A house is where it is, so it is not subject to evasion.

That is for the moderately rich; there is a whole separate issue with regard to inheritance tax avoidance and evasion by the extremely rich. I have views on that as a citizen, but I did not come here primed to give them. It is an area that I would hope that this Parliament and the Westminster Parliament would look at.

Gavin Brown: I will ask my last question with a slight twinkle in my eye. You have spoken about the devolution of taxation for North Sea oil. If that were to happen, there would obviously be a block grant adjustment, as we have seen with LBTT and landfill tax. If there were to be such an adjustment and oil taxes were to be devolved, do you think that the Scottish Government would stand by the oil revenue projections that it came out with a couple of months ago?

Professor McLean: That is a question on which I am damned if I say yes and damned if I say no. The Scottish Government can make whatever projections it wishes, but the revenue will be whatever it is and any forecasting body needs to make projections to do sensible planning of future

spending commitments. That is as far as I dare go, as I am aware that members round the table will hold opposite opinions on that question.

Gavin Brown: I am grateful.

Jean Urquhart: A couple of points arise from some of the things that you said, Professor McLean. One that comes up often concerns variations in taxes across the border. It is suggested that if, for example, we were to tax cigarettes really highly, there would be a massive warehouse in Cumbria or in Scotland, depending on the variation. Is that really a concern elsewhere? The border of every other country in Europe is crossable—we can cross from Northern Ireland to southern Ireland and so on. That does not stop variations in tax on wine, for example. People in England can and do nip across the Channel and come back with crates of wine. Is it seriously a consideration?

Professor McLean: It is a consideration for sure but, as I said earlier, it is one that the Parliament cannot do much about. Some people will jump in their cars and drive 100 miles for a few pence off something and others will not. Scotland is relatively lucky because it happens to have a thinly populated border. The issues are more difficult for Wales and much more difficult for Northern Ireland.

That would limit the freedom of the Parliament to set tobacco taxes, for instance, but it would not take it away. The Parliament would still have the freedom to set them. It is interesting that the data from “Government Expenditure and Revenue in Scotland”, which I recycled in table 2, shows that tobacco duties come joint second after the aggregates levy in the figures for Scottish revenue as a percentage of UK revenue. That says that there is more revenue from tobacco duties in Scotland per head than there is in the rest of the UK. Were tobacco duties to vary, some people would drive to Carlisle for their smokes, of course, but not everybody would.

Jean Urquhart: The other question that I have concerns the costs of devolving taxes. During the pre-referendum debate, those were cited as unthinkable but, to my uncertain knowledge, they were not mentioned at all when it came to the vow. Do you have a view about that?

Professor McLean: The costs of setting up a tax administration were an area of controversy before the referendum. Indeed, I had some involvement in that because my academic colleague Patrick Dunleavy from the London School of Economics produced some numbers that, I have to say, were unrealistic and misleading. When we drilled down into his numbers, it turned out that his estimates of the cost of setting up an independent Government

were actually the same as everybody else's and it was just that he had used a label that he called transition costs.

If the vote had been yes, those costs would have been inevitable. Given that the vote was no, the costs are, to some extent, optional. Parliament can decide whether to expand the capacities of Revenue Scotland to cover every tax or to have an agency arrangement with Her Majesty's Revenue and Customs. I do not know which would be cheaper. The opposite points have been made in the discussion that, on the one hand, there are economies of scale and, on the other, taxing 5 million people might be less expensive per head than taxing 60 million people. I do not know the answer to those questions. They are weighty matters that would have to be explored further.

11:45

Jean Urquhart: Finally, on your support for a land value tax, I hear what you say about people who want to raise the issue of a land value tax being seen as mad, but do you agree that it really should be debated and seriously considered in Scotland and that it could, in fact, be quite a large revenue earner and, indeed, fairer than either the council tax or the business rates that we currently collect?

Professor McLean: I do think that, but mostly as a citizen rather than as an academic—I must stress that. On the fairness point, to repeat myself, there is a very strong argument, which was made by Smith and Ricardo, that land should be taxed in proportion to its value and a land value tax is the least distorting of taxes. On a personal note, when I was about 15, I picked up Tom Johnston's "Our Scots Noble Families", which was first published in 1909. I think that it was the greatest radical manifesto of its era in Scotland, but when I commend that, I am speaking as a citizen and not as an academic, which members will already know.

Jean Urquhart: So that I am clear about the difference, what if you were speaking as an academic?

Professor McLean: Speaking as a citizen, if I had a vote in Scotland, I would vote for whichever party made promises to introduce land value tax. Speaking as an academic, I have to say, "Here are the advantages and here are the disadvantages." An obvious disadvantage of any tax change is that there would be losers, and you would hear from them for sure; indeed, I think that you are already hearing from the losers. With any major tax change of that sort, we hear much more from the losers than from the winners. For what it is worth, that would be my advice as an academic.

Jean Urquhart: Thank you very much, Professor McLean.

The Convener: Funnily enough, I was just saying exactly the same to Jim Johnston. The issue is not just that we hear more from the losers; it also depends on how many losers there are relative to the number of winners and the extent to which they lose out.

The committee's questions have concluded, but there are one or two things that I want to round up.

Table 2 in your submission is entitled "Current revenue, Scotland 2012-13, including geographical share of North Sea, in descending order by tax". It is, of course, interesting that gross operating surplus is fourth highest in that table and Scotland has a disproportionate share of that. Can you give us a wee bit of detail about what that is specifically and why Scotland has a very high share relative to its population?

Professor McLean: Yes, convener. I noticed that, as well. I have simply recycled numbers that your Government produced in the GERS series, so I do not know. It would be easier for you to ask the GERS team to come and give evidence. However, I assume—I think that this is the assumption behind your question, too—that that arises because there are functions of Government that are public in Scotland and private in England. Water comes to mind. I do not know whether that is the correct answer; I advise you to check with the GERS team.

The Convener: Yes. To be honest, the issue was not so much the content; it was more the proportion. However, that is a reasonably good answer.

We have talked about the costs of setting up an independent Scottish tax system or enhancing the tax system here through Revenue Scotland or whatever and the differences in costs. Before the referendum, the Institute for Fiscal Studies said that, if we start a new tax system more or less from scratch, we can obviously get rid of many of the horrendous anomalies that exist in the UK system. I—and, I am sure, all MSPs—got a thing through that said that some £34 billion remained uncollected from the 2011-12 financial year. That is 6.8 per cent of the UK's tax take. We are not talking about money that HMRC has said people do not have to pay because of some kind of avoidance arrangement. That money should have been collected. That uncollected £34 billion is more or less equivalent to the entire Scottish budget, of course.

If such tax powers were devolved to Scotland, given that we would have not quite but almost a clean sheet of paper, would that allow us to make a much more efficient tax-collecting system? You hinted that running a tax system for 5 million

people might be easier than doing so for 60 million people.

Professor McLean: There are arguments on both sides. It might be easier to run a tax system for 5 million people, and it might be easier to chase tax avoiders. On the other hand, the very fact that new differences between Scottish and rest-of-the-UK taxation would be created unfortunately and inevitably in itself would create more opportunities for tax avoidance.

There is a notorious historical example from Northern Ireland that has been on the public record for a long time. The Vestey Group meat corporation took advantage of a tiny provision of Northern Ireland tax law that nobody else had noticed to almost exempt the company from tax, in effect, although it had no domicile in Northern Ireland. One would be balancing the greater ease in going after avoiders in a country of 5 million than in a country of 60 million against the new opportunities for avoidance that any variation in tax rates automatically creates.

The Convener: Would there be more opportunities? If there was a principles-based system as opposed to a rules-based system, surely that would reduce the likelihood of avoidance, because it would be a matter of what was meant through the principle rather than the specific wording of legislation that has tied the UK down in 300 different tax-avoidance rules that it has had to specifically develop.

Professor McLean: I can only perhaps cynically refer to the title of a book by my colleague Andy Wightman, whom I mentioned earlier: "The Poor Had No Lawyers". The converse of that is that the rich do have lawyers.

I will leave it there, convener.

The Convener: Okay. Thank you very much for that.

Given that we are now in the winding-up session, are there any further points that you wish to make in addition to anything that you have said? Have any light bulbs switched on in the past hour or so, for example, along with the inheritance tax one?

Professor McLean: I think that we have covered everything that I came here expecting and hoping to cover. Thank you.

The Convener: Thank you very much. The committee certainly appreciates your forthright answers to our questions.

11:51

Meeting continued in private until 12:19.

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