The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

FINANCE COMMITTEE

Wednesday 12 November 2014

Session 4

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FINANCE COMMITTEE
28th 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 Jim Gallagher (University of Oxford)
John Hamilton (Scottish Property Federation)
Philip Hogg (Homes for Scotland)
Ian Honeyman (Scottish Building Federation)
David Stewart (Scottish Federation of Housing Associations)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Finance Committee

Wednesday 12 November 2014

[The Convener opened the meeting at 09:30]

Draft Budget Scrutiny 2015-16

The Convener (Kenneth Gibson): Good morning and welcome to the 28th meeting in 2014 of the Finance Committee of the Scottish Parliament. I remind everyone present to turn off any mobile phones or other electronic devices.

Our first item of business today is to take evidence on the Scottish Government's draft budget 2015-16 from Philip Hogg, the chief executive of Homes for Scotland; John Hamilton, the chairman of the Scottish Property Federation; Ian Honeyman, the commercial director of the Scottish Property Federation; and David Stewart, the policy manager of the Scottish Federation of Housing Associations.

Members have received submissions from each of our witnesses, so we will go straight to questions. I will start with a few opening questions before opening out the session to colleagues. I was impressed by the quality of the submissions that we received. They were excellent. Some of the questions that we will ask this morning are answered in the submissions, but it is important for the *Official Report* that we address some of the issues in greater detail.

There are many areas to ask about, but I will start with the submission from the Scottish Property Federation. I invite anyone to comment in response to any question, no matter who it was directed to. We want to get as wide a range of responses as possible.

The Scottish Property Federation talks about the approach to the land and buildings transaction tax and suggests that it would have been prudent to have allowed Scottish ministers greater freedom to set competitive tax rates and thresholds. Could you briefly go through your thinking on that? I do not know whether Mr Hamilton or Mr Honeyman would wish to answer that question.

John Hamilton (Scottish Property Federation): I am happy to answer on behalf of the SPF. We welcome the change to a progressive system. We think that it is an excellent introduction, which is of benefit to the residential and commercial markets.

We also believe that the Scottish Government could think about the position with regard to the ability of developers to trade within the United Kingdom. The bands and rates that have been introduced would merit some adjustment in order to give Scotland the sort of advantageous trading position that the new system could introduce.

The Convener: Before we go on, I apologise to Mr Honeyman. In my briefing, he is listed as being from the Scottish Property Federation, but he is, in fact, from the Scottish Building Federation.

What would be the impact on revenue of the changes that have been suggested? Aside from its progressive nature, one of the important things about LBTT is the Scottish Government's view that it wants to keep it broadly revenue neutral. We do not necessarily want to raise more tax; it is the distribution of taxes that we want to address. How would your suggestions ensure that we continue to have that revenue neutrality?

John Hamilton: We accept the position on revenue neutrality.

The base information could perhaps be reconsidered after the first year or two of operation. It is difficult to predict exactly how the markets would respond to this kind of change—the introduction of a new tax system in Scotland is quite a major change, and there will be a lot of sensitivity around it—and we think that, in the first year or two of its operation, its impact on the market will not be clearly understood. However, over a short period, depending on the quality of the data that is used to make market assessments, a position of neutrality could still be achieved, which could allow for some competition within Scotland. That could attract investment to the industry.

The Convener: In effect, you have suggested that a new banding be created.

John Hamilton: Yes.

The Convener: That would mean a softer move from 2 to 10 per cent.

John Hamilton: Yes.

The Convener: What impact might that have on the wider property market?

John Hamilton: We think that the change in bands is too severe. It will possibly lead to some distortion in the market, with people making decisions on whether or not to proceed with a transaction. That applies to both the residential and commercial markets. We do not think that such a severe change in the bands and the rates will add a positive aspect to investment decisions made in Scotland compared with those that are made in the rest of the UK.

The Convener: Does any other witness wish to comment on what Mr Hamilton has said?

Philip Hogg (Homes for Scotland): I endorse what John Hamilton has said. We broadly welcome the model and the new system, and the removal of the steps or slabs that created distortion. We are very supportive of that. Generally, through the comments in our submission and through what I wish to discuss this morning, we are suggesting how the system could be tweaked—it is not a matter of wholesale engineering.

To pick up on a point that John Hamilton made, although we acknowledge and welcome the fact that purchasers below £325,000 are likely to pay the same or less tax, the net effect is that the tax burden on those who are purchasing properties above £325,000 has to be considerably more. I suspect that there will be little sympathy for people purchasing in the very high hundreds of thousands of pounds, but we believe that there is a critical price point between £325,000 and around £500,000, where the tax increase will be in the region of 40 per cent, which is a significant increase.

There may be little sympathy for purchasers in that area, but we need to consider not so much the emotions around that but what that might do to the marketplace. To have an effective system, we need to have price movement through all stages of the market. We need people to move upwards to vacate properties at the entry level to allow first-time buyers through. If we create stagnation or a lack of movement at any point in the marketplace, that could have the effect of stifling movement at the lower levels. That is our concern, and that is why we suggested that a new band should be inserted between £250,000 and £500,000, which would relieve the tax burden a little bit. We are still suggesting that the payment would be more, but not by as much.

Turning to the consequence or risk of that not happening, we understand that the majority of the tax will fall on the very highest 10 per cent of purchasers. There is a risk that, if those potential purchasers simply decide not to move because the tax is too high, the forecast tax intake could be less than has been considered.

We have to note that, as a result of the financial crisis and the housing market collapse, many people are sitting in properties that are probably worth a lot less than they were many years ago, so their equity in those properties is a lot less than it would have been then. Whereas, traditionally, people would have moved up the housing ladder and would have had equity that they could use to pay off the stamp duty, there is now less of that equity around. Moving upwards is therefore less affordable. We believe that that could create stagnation in some sections of the market, which, ultimately, could impact on tax take and overall movement in the market.

The Convener: We are talking about around 5 per cent of the overall housing market being disadvantaged, given that anyone who buys a house that costs less than £324,300 will actually be better off in terms of tax. Is one of the issues that you have to do with geography? Obviously, some areas of Scotland are poorer than others, so there will be a differential in the number of affected properties in specific areas. Is that a concern? The measure might be more impactful in areas that are more prosperous than in other areas.

Philip Hogg: There is an element of that, but it is not necessarily to do with areas being more prosperous—it is the sheer cost of housing in some localities. It is just more expensive in some areas. It is just one of those facts that certain geographical areas have more expensive properties. We—

The Convener: Sorry, but the most prosperous parts of Scotland clearly have the most expensive houses, such as East Renfrewshire, Aberdeenshire, East Lothian and Edinburgh. Where I am in Ayrshire, not many houses sell for more than £324,000.

Philip Hogg: As I said, we propose a more even spread of the tax take through the bands, rather than a very steep increase when it goes across that neutral point. We are just asking for the spread to be evened out. We support the idea that people at the lower end should be given a tax advantage—in other words, they pay less—but we think that the increase could be evened out, rather than being as steep as it is at present.

The Convener: If the 10 per cent tax on houses with a value of £0.25 million to £1 million has the impact of reducing house prices in overheated areas such as Edinburgh and Aberdeen, would that not be perceived by some people as a good thing?

Philip Hogg: We have to be careful in thinking about reducing house prices. Our members' experience has shown that home owners have a belief of what their property is worth. For many of them, when they consider selling or moving and find out that their property is worth less than they had thought, that will result in their simply not moving or having a higher expectation than they should, which creates stagnation. Our members have noted that and reported back that it has been a significant effect over the past few years, particularly when they offer part exchange for home movers. When the home mover is told how much their property is worth, they simply say that that cannot be true because they paid X or that they have heard that property prices are moving up. Accepting that their property is worth less than they thought is a difficult pill to swallow for many. If they accept it, that will impinge on their existing equity and therefore their ability to pay the tax.

The Convener: Just for perspective, I should point out that the average price of a detached house in Edinburgh in August 2014 was under £242,000.

John Hamilton: The Scottish Property Federation sees more benefit in adding stimulus to the lower end of the market and improving the quality of housing in the market rather than imposing the most severe rates of tax on the higher end of the market, which basically looks at the problem from the other angle.

The Convener: Thank you.

Mr Honeyman's submission states:

> "The transition to a progressive system of taxation of property transactions will undoubtedly have a positive impact on the property market and the wider economy by eliminating current distortions in the market, caused by the existing slab structure of SDLT."

Will you expand a wee bit on that perspective, Mr Honeyman?

Ian Honeyman (Scottish Building Federation): Obviously, the existing system has issues. We believe that the transition to LBTT will probably benefit more people than it disadvantages. As you pointed out, there are geographical issues, in that the perception of the tax will be different in different areas. That cannot be changed, because we are where we are geographically. One issue that the tax will address will be that of promoting growth at the bottom end of the market in more affordable housing. We are all crying out for that to get the housing market moving again.

There are issues with regard to the step up from 2 to 10 per cent. In essence, our concern is that, if the tax is to be neutral overall, we need to make it relatively fair across the board, and it must be seen to be fair. If it disadvantages people—as I said, the mark around £325,000 has been flagged up as a line in the sand—there is an issue. People may decide at the £325,000 mark that they will not move because they would rather stay where they are and invest. That could be quite good for the construction industry in general, but it will not help the housing market. People still aspire to move up the ladder, and it is possible that such a change would create a problem in the market, although not everywhere.

09:45

As the convener pointed out, those in the majority of houses in the lower bands will probably be better off as a result, which will stimulate the market. I think that those in more affluent areas of Scotland would be prepared to pay extra money as long as the tax was not viewed as punitive in relation to their particular circumstances.

The Convener: The committee's adviser, Professor McEwen, has said that taxation at the higher end is not as much of a consideration for people who are trying to move house as one might think. How much of a consideration do you believe it is?

Ian Honeyman: We should remember that people who want to move up the way must be able to afford to move—we are not talking about the point when they are already there and have the equity in the property. It is the transition that is a big step. If somebody is making the decision to move from a £180,000 house to a £300,000 house, that move will, if they can afford it, suddenly appear to be a bigger step than it would otherwise have been. That is the issue that needs to be looked at.

The Convener: Someone moving from a £180,000 house to a £300,000 house would still be better off.

Ian Honeyman: Yes, they would be, but when they step above the threshold there is an issue. The whole market is a chain, to a certain extent. We believe that some of the issues would be addressed by the introduction of new housing, as a lot of first-time buyers are not looking for existing housing. If there were more new properties on the market, that would stimulate the housing side of things.

The Convener: Mr Stewart, you broadly support the proposals in that respect, so I will not go into that particular area. Your submission focuses on other areas. I will not talk about low-carbon homes, because I am sure that other colleagues at the table will want to ask you about that specific issue and I do not want to steal their thunder.

Can you talk about the issues in relation to housing, such as providing houses for mid-market rent through non-charitable subsidiaries, and about the impact that the legislation might have in that respect? Your submission is a wee bit different from some of the other submissions.

David Stewart (Scottish Federation of Housing Associations): In a way, housing associations that are developing properties for mid-market rent might seem to be a small consideration. However, it is a huge part of their business, which tends to focus very much on areas where the market is strong and where there is pressured area status—for example, in Edinburgh and Aberdeen.

As you say, we broadly support the tax. However, there is one possible cause for concern. We understand that, where non-charitable subsidiaries of housing associations provide houses for mid-market rent, they are buying multiple properties from developers. The nature of the new tax is a result of the fact that it seeks to charge proportionally higher levels for higher-value transactions. We understand that a housing association would, in that case, pay more than it previously did for stamp duty, and we would like a further relief or exemption to avoid that issue.

The Convener: I am keen to let colleagues in, so I will ask questions on one more area. I have a question for Mr Hamilton on commercial property sales. At paragraph 6.1 of your submission, you state:

> "This final top rate of LBTT is really the bellwether by which the property investment industry will set its yields for investible property in Scotland or proposed commercial development appraisals."

You express some concerns about the 4.5 per cent rate. Can you talk us through that, and tell us what sort of investments you are talking about?

John Hamilton: Yes. Our main concern is that the tax will be seen as an added cost of investment in Scotland. It creates a differential between the cost of investing in development and developing existing stock in Scotland, setting it apart from the rest of the UK. Many of the decisions about property investment are made at the margins. Although it might not seem that 0.5 per cent would make a great deal of difference, it could do so at the margins.

In general, for multimillion-pound investment projects such as the Haymarket development in Edinburgh, even 0.5 per cent of the cost of the transaction would be seen as having a net detriment with regard to investing in Scotland versus investing in England or Wales.

The Convener: Mr Honeyman, your submission contains some interesting comments on the topic. Can you talk us through your views?

Ian Honeyman: With regard to the commercial aspect, the transition happens at around the £2 million mark. When one looks at the overall figures, once one gets over that mark, the 0.5 per cent element climbs. I do not believe that it is so significant as to put people off undertaking a project; if they are making the decision on the project at that level, I would find strange the idea that the tax would make the difference between the development being profitable or unprofitable.

However, there are issues with regard to the actual spend on the project. I am sorry—I have lost my train of thought.

On the tax side of things, there is a significant amount of volume and suchlike around the £2 million mark. That is probably where the majority of the issues lie.

I am sorry—I have lost my train of thought totally. Please bear with me.

The Convener: Do not worry—we can always come back to that bit. I am sure that colleagues will want to ask about it.

Mr Hogg, you say in your submission that:

> "It is crucial that Scotland remains a competitive place to invest and bring forward housing development",

and you express concerns that the proposed 0.5 per cent increase

> "is not helpful."

Surely there are many factors at play in property development. For example, the cost of one hectare of land in London must be massively different from the cost in Glasgow. Surely the tax is only one relatively small factor in terms of such investment decisions, as Mr Honeyman pointed out. How important is it in the decision-making process? That is the question that I am trying to grapple with.

Philip Hogg: Building on the comments that John Hamilton made a moment ago, many of the major UK-wide home builders operate an internal market of competition when they are looking at a range of potential development sites. Each of the regional companies that build the homes must compete internally against their peer group for the group assets and the group finance. Anything that makes a development site in Scotland more expensive than a site down south will be looked at dispassionately by the group finance director, or whoever is the decision maker. They may say, "Well, we can achieve a better return on our investment from the site in Durham than we can from the site in Dundee."

That is where the economics make a difference. It is also a fact that home building is more expensive in Scotland anyway, as a starting point, because of the higher thermal energy standards that we have here. Construction costs are already more expensive, and through the tax we would be adding an extra cost. That may be viewed as a marginal cost, but it is that little bit extra that will make it a bit more difficult, and a little bit less attractive, to compete for funds in an internal market. We thought that it was appropriate to flag that up.

The Convener: Okay. I would like to explore the issue further with you, but I have taken up a significant amount of time and I want my colleagues to have an opportunity to ask questions. John Mason will go next, followed by Jamie Hepburn.

John Mason (Glasgow Shettleston) (SNP): The convener already touched on the area of mid-market rent, and I am interested in that. Have you done any studies on by how much rent would be affected, proportionally, by the proposal?

David Stewart: Not as such. The issue was flagged up by a member association that operates mainly in Edinburgh and the Lothians and has over 400 properties for mid-market rent. It was raised as an area of concern, but the cost might not be so much that rents would be affected. The rents tend to be set so that they sit somewhere between affordable or social housing rents for people who would not otherwise be able to afford a house, and what the market charges.

The concern is more about LBTT limiting the number of units that an association might buy or about the cost to the public purse. To develop a mid-market rent, you need land to be transferred at nil value or below market value, or you need some form of grant or mechanism such as the national housing trust, which the Scottish Government promoted. The tax would not affect all mid-market-rent properties. As I said, mid-market rent is not the main part of housing associations' business, but in a period when a lot of people cannot afford to buy until they are older, it meets an important need. We wanted to flag up that the tax might be a cost that could affect the ability to deliver.

John Mason: The mid-market rent is about 80 per cent of the private market rent, is it not?

David Stewart: Yes.

John Mason: Your written submission says:

"associations providing mid-market rent are meeting a housing need that would not be met by the market".

Presumably, it is making it a bit more affordable for some people who would struggle, but the reality is that they would have to pay the market rate otherwise, so they already have a 20 per cent advantage.

David Stewart: I suppose that you could say that they might have had to pay the market rate, but that ultimately could affect their ability to go into employment or impose a greater burden on the benefits system, which is obviously a concern because of welfare reform and changes to housing benefit. The aim of mid-market-rent housing is to meet the needs of people who would normally be housed through social housing if there was not so much pressure on it and who would struggle to pay a market rent or to buy.

John Mason: In paragraph 3.3 of your submission, you say that it is

"surprising that the government did not take the opportunity ... to incentivise energy efficiency".

We spent quite a lot of time on that issue when the bill was being considered. I think that the feeling then was very much that incentivising energy efficiency in the way suggested would not make a big difference to where people buy and that it would be an inefficient way, because if someone is not selling, they have no incentive to improve their house. Do you not think that it would be better to do energy efficiency by grants? Do you feel that tax is still the better way?

David Stewart: In an ideal world, it would be better to do it by grants. Scotland has very challenging climate change targets for carbon reduction and a commitment to end fuel poverty. We fully support those targets. In order to meet those challenging targets and to deal with the fact that fuel prices continue to rise, every opportunity and tool available should be used to provide the push towards, or to incentivise, energy efficiency.

We tried to make it clear in our submission that we do not think that using the tax on its own would lead fully to greater awareness of energy efficiency and greater investment. What we feel is that along with a range of other measures, such as the minimum standards that the Scottish Government plans to consult on and available funds such as the home energy efficiency programmes for Scotland scheme, the tax could provide a push in the direction of energy efficiency. We feel that, given the importance of the energy efficiency issue and the Scottish Government's commitment to it, every opportunity should be taken.

John Mason: Thank you. Other witnesses could have responded to those questions, but they were aimed specifically at Mr Stewart.

Mr Honeyman, I was interested to see a reference on the third page of the Scottish Building Federation submission to how your respondents saw the tax burden. It says that 50 per cent of respondents thought that the tax burden should remain the same and 44 per cent thought that it should be lower, so 94 per cent thought that the tax should either stay the same or be lower. For non-residential transactions, the figures were 63 per cent and 32 per cent, which means that 95 per cent thought that it should be the same or lower. Is that just those people saying that they think that there should be no tax or very little tax?

10:00

Ian Honeyman: It probably reflects the fact that our membership covers a wide range of operators in housing and commercial property. Some of them operate one-off houses. Everybody would like the tax to be nil but, generally, they are in favour of it staying as it was or being less. Nobody wants to pay more tax if they can avoid it.

John Mason: Are they taking into account the fact that we need to pay teachers and nurses or is that not really a factor for them?

Ian Honeyman: It is difficult to say. They probably look at the questions that they are answering from the point of view of how the tax affects their business rather than thinking about where it goes. All the tax goes into the pot and nobody knows where it is spent.

John Mason: When you say that

"nobody knows where it is spent",

what do you mean?

Ian Honeyman: People pay their taxes on property and the money goes into the Government pot.

John Mason: We know how the Government pot is spent, but property tax is not ring fenced.

Ian Honeyman: Yes. The money that is raised from property does not necessarily go back into construction, for example.

John Mason: No, but it goes into public services.

Ian Honeyman: Yes. I appreciate that.

John Mason: Mr Hamilton, I am interested in the Scottish Property Federation's comments on the Treasury and the block grant. Your submission says:

> "In the absence of any apparent Treasury demand on block grant reduction, we do not understand why the Finance Secretary did not opt for this approach"—

that is, projecting lower revenue, I think. Will you explain what you mean by that? We are having problems with the block grant and, as far as we understand, the Treasury is pushing to reduce it more severely.

John Hamilton: We might have touched on that point earlier. The amount of reduction in the block grant is not yet known because we do not yet know how much the introduction of LBTT will act as a stimulus or otherwise to the housing market and the commercial development market.

You can set a rate of tax and assume that the amount of revenue that you will raise will be constant, but it will not be constant. It will change partly as a result of the change in the tax regime and partly as a result of market conditions, which nobody can predict absolutely. We need to be cautious for the first year or two of the tax's introduction until we fully understand what its impact on the market might be and, consequently, how the block grant might be adjusted. However, there will be other reasons for that happening.

John Mason: Yes. You made the point that the amount of tax is based on transactions and house prices, which are affected by the market and the tax. I do not know whether you have done any studies on the matter, but how would you compare those two factors? I would think that the market going up or down would have a huge impact and the tax would have little impact. Do you agree with that?

John Hamilton: No, we do not agree with that. We are concerned about the idea that the industry can carry the added tax because it is only 0.5 per cent. As I said before, it is an added cost of investment and an added cost of doing business. Investors will not welcome that.

John Mason: Do people still do business in London? The cost is quite high there.

John Hamilton: Yes, but the reason why they do business in London is that it is seen as an attractive place to do business. Values in Scotland are not as high as they are in London.

John Mason: If we can make Scotland an attractive place in other ways, as London is—for example, if we have a better-educated workforce because we put more into schools and universities—can we counter some of those perceptions?

John Hamilton: Yes, but we would do that by increasing the amount of business that is done in Scotland and the amount of investment that is made here by making it an attractive place to invest.

John Mason: Land prices must come in here. A number of respondents have made the point about competition, but I would have thought that the land price would be a much bigger factor in the cost of the overall project than whether the tax rate was 4 per cent or 4.5 per cent or that kind of thing. Is that not the case?

John Hamilton: Land prices are not constant and it depends on whether you are talking about commercial or residential land. It might be that 20 per cent of the cost of a typical development will be the land. That is a sizeable proportion of the amount of investment in a project. On the bigger projects, whether the tax is applied to the land element or on a forward sale to the full development value, it is a significant cost.

John Mason: But if we look at a city like Glasgow, the land costs are higher in the west end than they are in the east end, but people want to build in the west end and not in the east end. It is not just a question of finding the cheapest place to go, is it? In that equation, even if the tax was 4 per cent in the east end and 4.5 per cent in the west end, people would still want to be in the west end, would they not?

John Hamilton: Well, they would, but we do not see it as helpful—in fact it is rather negative—to approach the issue from the point of view of dampening interest in investing in one area rather than another. We would rather see a stimulus being provided in the areas where we want to see improving values, whether they be land values or overall property or commercial values, and there are better ways of doing that.

John Mason: Have you done any studies on the impact of that 0.5 per cent difference on commercial properties?

John Hamilton: We have not had the opportunity to do that. Simply starting from a base of setting the rate and waiting to see what happens is slightly risky. Studies can be done over time, but it might take a year or two for the industry and the Scottish Government to do them.

John Mason: Thank you.

Mr Hogg, the first page of your submission talks about the balance between supporting the first-time buyer and the mid to higher values

"thereby creating too much of an imbalance within the market."

Some people feel that there is already a huge imbalance in the market and in society, for that matter, and that some people have a huge amount of money and huge properties and others have little money and little properties, and that LBTT will redress the balance a bit. Would you be open to that argument? How do you respond to that?

Philip Hogg: Indeed I am open to that argument. To reiterate, we broadly welcome the proposal that has been made. We are seeking to suggest refinements, so we are not suggesting an overall reduction in the tax take; we are just suggesting that the distribution of the tax could be more even. From our paper, you will note that we support a reduction in the tax for the lower end of the market. We think that it could be more evenly spread towards the middle of the market so that the distribution is smoother.

I want to put the picture into context. We are still in the midst of a housing crisis, with only 15,000 new private and social homes having been built in the past year. We collect data from the majority of our members, who deliver about 95 per cent of all the new homes that are built in Scotland, so we have a reasonable finger on the pulse of what is happening.

In the early part of this year, we saw significant signs of growth. However, as the year has moved on, our forecasts are that housing output this year will be broadly the same, so we will see no increase in total housing output. Whichever way we look at it, we are not eating into the challenge that the Scottish Government recognises of needing to increase housing output.

We want to see how the new LBTT system can support that growth in housing output, so our paper is purely about recommending ways in which we think that we could engineer the system. We welcome the removal of the slab system, but we need ways of further engineering the system and we need to remove some of the tax on bulk purchases, which will have a significant impact on large-scale and large-volume investment.

I may be switching around a little bit, but I think that this is relevant. The Scottish Government has recently supported our organisation with the appointment of a private rented sector champion. His role is to attract institutional investment for the large-scale construction of privately rented properties that are professionally managed and of the highest quality. The Scottish Government is supporting us through that project. We need a professionally run large-scale private rented sector, like we have in many parts of Europe. However, the proposed tax system will undermine that, because the proposed tax on large-scale multiple purchases will be significantly higher than it is now.

We recognise that tax must be gathered, for all the reasons that John Mason points out, but we are looking to tweak the process to make it more effective, in line with other policy requirements.

John Mason: You raised the valid point that we need more homes and houses. From society's point of view, if we have £1 million, do we want one house for £1 million or 10 for £100,000 each? Based on your argument, it seems clear that as we need more houses, we should have more smaller or cheaper houses at the bottom end. That is what will benefit society; a few £1 million houses will not benefit us. Should we do all that we can to push the investment down to the bottom end, and let the top end take care of itself?

Philip Hogg: We need a mix of housing. As I said, as people's lives change—as they have families and as their jobs require them to move around—they need homes of a suitable quality for their purposes. With the booming oil economy in Aberdeen, arguably there is a need for higher-value properties there. If we do not cater for higher-net-worth individuals, we will have a commuter society, in which people fly in, live in rented accommodation during the working week, then move out again. For the long-term sustainability of each economy we need the appropriate mix of housing.

We need housing at all levels, across all tenures. We are fully supportive of that argument. That is supported by each local authority developing its housing needs and demand assessments, which feed into local plans.

John Hamilton: The measures are correct in having a zero tax rate at the lower end of the market, which will encourage properties there to be built and sold. That is good and fine, but in the overall tax take there will have to be enough of the bigger properties. Tax must be collected on those properties to fund the tax that is not being collected in the lower end of the market. That must be balanced.

Jamie Hepburn (Cumbernauld and Kilsyth) (SNP): Mr Hogg, in your exchange with the deputy convener you suggested that the rates should be altered to even out the rates to the middle of the market. You have suggested a new band: 7 per cent from £250,000 to £500,000—I presume that that is what you are talking about. However, it is not right to call that the middle of the market, is it? Maybe it is the middle range in terms of rates, but we know that the Scottish average house price is £170,000 and even in Edinburgh, where house prices are higher, it is £235,000. To call that range the middle of the market is not quite telling the full story, is it?

Philip Hogg: Okay, let us call it the middle price band in the range that has been put forward in the submission. I am not trying to attach a label with any socio-demographic meaning to the band. I was saying that notionally that is the middle range of numbers in the range of bands from zero up to 1 million. I was not talking about middle incomes or middle house prices.

I reiterate that we need the market to move at all levels. If the market stagnates at the £325,000 to £500,000 point, it will not release properties at the lower levels, which will stop first-time buyers moving upwards. I am sure that many of us who have moved house have been stuck in the notorious housing chain, waiting for the purchaser of our property to sell before we can move on. We are all familiar with the chain concept. Some of us might have had unfortunate experiences whereby the chain has broken down at various points. We are saying that we need that section of the market—let us not call it the middle of the market, if that causes a problem—to be able to move.

I mentioned diminishing equity. In previous years, many people who were moving on to their second or third property had enough equity in their home to be able to afford the stamp duty. I am looking at some figures that show that Scottish house prices are still below—about 4 per cent below—their pre-crisis peak. There are many people who do not have the equity that they would traditionally have had, and we think that that could create a problem.

In addition, a number of our members have reported back that some customers who had reserved homes that they were due to move into from April 2015 onwards have come back to them because they have suddenly realised that they face a bigger tax bill and have asked what they intend to do about it. They have told our members that, if they cannot cover that additional tax, they might have to cancel the purchase. An element of trading and negotiation will go on in such situations—that is part of commercial life—but if we are talking about a private seller of second-hand property, that could jeopardise the chain. The seller could say, “I’m sorry, but I can’t afford to lower my price any further.” There is already evidence of some movement around the bands.

10:15

Jamie Hepburn: That is helpful, and I welcome the clarification. I thought that it might be a bit misleading to use the phrase “middle of the market”, but your clarification has been useful.

In your submission, Mr Stewart, you look at how the mid-market rental sector could be affected; indeed, the convener and the deputy convener have already explored the issue with you. I think that you said that the issue had been raised by one particular housing association. Could it be peculiar to areas where house values are higher than in other areas? You said that the housing association concerned was in Edinburgh. How many housing associations purchase properties for more than £135,000, which, as we know, is the nil value threshold for LBTT?

David Stewart: The issue is not so much about the cost of an individual house; it applies in cases in which there are multiple transactions, which are treated as a larger sum, and the tax is applied as if it were a commercial transaction. You are right to suggest that the issue does not apply across Scotland and that it does not affect every housing association. As I have said, mid-market rent is only really found in areas with pressured area status, such as the west end of Glasgow and cities such as Aberdeen and Edinburgh. I want to make it clear that the issue relates only to a relatively small proportion of transactions, and it does not apply to, for example, mid-market rents that are developed by the housing associations.

I will give you an example. During the property crisis that Philip Hogg referred to, housing associations made some quite large-scale purchases—they either bought properties from developers and completed them or bought completed properties—which they now rent for mid-market rent. Those are the kind of transactions that I am talking about. They take place in areas where younger working people or people in slightly lower-paid employment would otherwise struggle to secure a quality property.

Jamie Hepburn: I think that you have raised a reasonable concern. If we wanted to look further into the issue, could you refer us to any significant studies or provide us with any work that has been carried out?

David Stewart: I discussed the issue with the member who raised it. The concern arose from something that a tax partner at a law firm said at an event that the member attended. I would be happy to go back to that member or to approach the tax expert who raised the issue to quantify what sort of sums we are talking about and which transactions might be affected.

Jamie Hepburn: That would be helpful. If you could go a bit wider than that and give other examples, that would be better still.

David Stewart: Absolutely.

Philip Hogg: I have an example that might illustrate David Stewart's point. We have worked through an example of 50 flats at an average price of £150,000—to select a random number—which would make a total purchase of £7.5 million. That is the sort of unit size that housing associations or investors might look for. Under stamp duty land tax—the tax that is in place at the moment—the stamp duty payable would be £75,000. Under the proposed new LBTT system, the tax would be £131,100, which is £56,000 more, or a 75 per cent increase. The magnitude is significant—it is a major increase. For housing associations and large-scale investors, that increase of £56,000 could well be a dealbreaker.

Jamie Hepburn: I just want to clarify that housing associations' main business is, as the SFHA submission states, exempt. The point that we are discussing relates to a specific subset of housing association business.

David Stewart: Absolutely. It is a specific point for associations that do mid-market rents and which, because of the rules on charities, do so through non-charitable subsidiaries. It is a specific point and does not affect the majority of association developments.

Jamie Hepburn: Notwithstanding that, we should consider the issue further so, if you can provide more information, that would be helpful.

David Stewart: I would be glad to do so.

Jamie Hepburn: My final question is for Mr Hamilton. In his exchange with the deputy convener, he made the point that the sector needs stimulus. He seemed to be talking about the higher end, but will the tax changes not provide stimulus? We know that 95 per cent of transactions will involve either the same or less tax, and we also know that the average house price is, as I have said, about £170,000 and that a person or family going through a transaction on such a house will save nearly £1,000. Even with the Scottish average for a detached property, people will make a saving of £257. So the tax changes are a stimulus, are they not?

John Hamilton: Yes. As I have said, we support the measures at the lower end of the market.

Jamie Hepburn: I am sorry, but that is not the lower end—that is the average.

John Hamilton: Yes, but as we have said, the whole market has to be balanced. We believe that there should be a full range of choice in the market, because people could be pushed into making decisions that they would not otherwise make. The whole tax and collection regime seems to be based on the assumption that people who buy expensive houses do not care about the tax, but we do not think that that is right. We are talking mainly about residential property. Anyone who buys at any level of the market carefully considers the cost of the transaction. If we do not set the tax rates correctly, distortion and problems will arise as a result of our, in effect, subsidising the lower part of the market.

Jamie Hepburn: You have said that this is a subsidy, but surely it is a stimulus, which is what you have called for. It is a stimulus in an area in which more people will take advantage of it.

John Hamilton: Yes, we agree with the stimulus, but the stimulus has to be funded.

Jamie Hepburn: I presume that it will be, because the proposals are revenue neutral.

John Hamilton: No tax will be applied at the bottom rate, which is a good thing and is absolutely correct. However, that is the position now, so fundamentally there is no change in that respect.

Jamie Hepburn: The threshold has been increased by £10,000.

John Hamilton: Yes, but no other change apart from that has been made. We do not see that move as negative at all, and we can support it. Fundamentally, though, if tax is not being collected at the lowest bracket, it will have to be collected elsewhere, and it can be collected only at the upper levels. The change from 2 per cent to 10 per cent in the tax band that is applied will lead to people deciding not to proceed with transactions that we would like to take place. There should be a more even spread of tax being applied.

Jamie Hepburn: In a survey of the members of Mr Honeyman's organisation,

> "63% of respondents indicated that higher value property transactions should bear a larger share of the overall tax burden under LBTT compared to SDLT."

That is what the proposals are delivering.

John Hamilton: Those transactions already bear a higher tax burden.

Jamie Hepburn: But this is in comparison with stamp duty.

John Hamilton: We are not disputing the principle; we are disputing the amounts and the changes in the tax bands and rates.

Gavin Brown (Lothian) (Con): Starting with residential property, I wonder whether you can you give me your best-case or central scenario for the overall impact on the housing market if the proposed tax bandings and levels as set out in the draft budget go through.

Philip Hogg: As I have mentioned, we are already seeing evidence of a short-term shuffling around of housing transactions. People who had reserved a new-build property, who were planning to move in next January, February or March and who will be paying less than £325,000 are, as you would expect, keen to defer. They are asking whether there is any chance that they could push their moving date back to April in order to pay less tax. On the other hand, those who are potentially facing a higher tax bill are looking to do the opposite; they are trying to bring their purchase forward to get in under the existing rates. In cases where that will not be possible, people are looking to our members to subsidise or share some of the burden. All of that is understandable; after all, there is always some short-term movement with any tax change.

In the medium term, the bands could settle down as people become familiar with them. However, there is some confusion around. We support the change to the system and the removal of the slab rate, but some people are already assuming that, for instance, they will have to pay 10 per cent tax. That is not the case—it is 10 per cent on the amount above the band threshold. Some market communication is needed, and people need to become aware that the situation is not as bad as they might perceive it to be.

Our big concern is what happens in that middle band—I should stop calling it the “middle”—of properties valued from £325,000 to about £500,000. At this stage, we are all putting our fingers in the air and guessing. I cannot say any more, apart from mentioning the short-term movement that we are seeing in and around the proposed changeover date.

Gavin Brown: Is it your contention and the view of your organisation that the higher rates on houses valued over £325,000 impacts not just the buyers and sellers of those houses but the market as a whole, as it is all interconnected?

Philip Hogg: It is indeed all interconnected. I have already used the illustration of the housing ladder. If we create stagnation—that might be the wrong word; perhaps I should say inertia—in one part of the market, that will have a push-down effect on other parts of the market. We need the chain to move fluently and freely if we are to have a healthy, functioning market.

If we could smooth out the graduation immediately above the £325,000 level, we would have a very good tax system. The proposed system is better than where we were, and we think that the improvements that we are suggesting would make it even better.

John Hamilton: There is a phenomenon that we might refer to as price crowding, which happens more in a slab tax system, where the market prices properties at the most attractive tax band. If the tax band is not set correctly, too many properties get sold on the market at that price band. It is slightly easier to control that with a progressive rate of tax, but if there are severe differences between the rates and the bands, too many properties will still be offered at a certain price point in the market for the market to work effectively.

10:30

Gavin Brown: You have suggested that some transactions might not go ahead, and that people might just stay put. I realise that it will be difficult to know this, but how likely will that behaviour be if people feel that they will pay too much tax?

Philip Hogg: On the basis of previous experience, even removing the issue of tax, we know that price deflation in the housing market is a real catalyst for stagnation. People assume that their property is worth a certain amount, and if they are considering moving, they will have in their mind what they think the property is worth. They might have as a reference point a neighbouring house or a house adjacent to theirs that sold a year or two back, and I would suggest that, human nature being what it is, people will think that if that property achieved that price, their property must be worth at least X.

However, when price deflation happens—in other words, when an agent, property expert or valuer comes to assess a property and tells the customer that their property is worth less than they thought—many people are deterred from moving. They either think that they will sit tight and wait for property prices to improve or simply say that they cannot afford to move. That is the effect of that situation, and there is the potential—I do not want to overstress it—for that to happen in that price band.

Gavin Brown: You have said that there is the potential for it to happen, but if it did and there were fewer transactions than were predicted, the tax take at various levels would be affected.

Philip Hogg: That is a good point. If the tax take at that level is dampened, that will compromise the overall tax take, which is meant to offset the lower tax take that is expected at the lower level. That is a risk in the system that, I suspect, is difficult to model and predict.

Gavin Brown: Various of your organisations have suggested amendments or tweaks to where we are. Let us start with Homes for Scotland, which has proposed a rate of 7 per cent for properties valued between £250,000 and £500,000. I note, however, that you would leave everything else as it is—for residential properties.

Philip Hogg: That is right. We have made other suggestions for reliefs in other areas, which we might cover later, but that is broadly our proposal. We have also suggested moving the minimum level up to £135,000. In the absence of the full data, we have made that suggestion to offset or rebalance things, but we do not have the full data to work out a fully costed model of what that would deliver in total tax take.

Gavin Brown: Out of interest, what was your reason for choosing the £250,000 to £500,000 band? Do you see that as a particular band in the current market?

Philip Hogg: Our members tell us that it is important. The £250,000 figure has historically been a significant price point in the market. As John Hamilton has mentioned, in the current tax system, there is an enormous tax increase when the cost of a property goes from £249,999 to £250,000. The tax increases from £2,500 to £7,500, so for an extra £1 on their property someone pays £5,000 in tax. As a result, home builders cannot design, construct and market a property anywhere near £250,000 or £275,000, so there is a gap in the market, and we would welcome easing out that situation. However, the £250,000 to £500,000 band relates to an important section of the market: family homes for aspiring growing families in some—but I accept not all—geographies. It is important to keep that part of the market moving.

We can draw our own conclusions about affordability beyond £500,000 but, under the proposed system, that part of the market is, as we have said, getting about a 42 per cent tax increase. That increase could be spread a little further among the lower bands.

Gavin Brown: Does the Scottish Property Federation hold a similar view?

John Hamilton: Yes. We have also suggested a mid rate of about 5 to 6 per cent in the same band that Homes For Scotland has highlighted.

As far as houses up to £250,000 are concerned, I note that Homes for Scotland generally looks at new-build property in its own business sector, and a key aspect of such properties is that they must be constructed. However, with the houses that we have been talking about, there is only a certain amount of flexibility in construction costs. As you move up the chain, there is potential for builders to provide a wider range of high-quality housing. People generally aspire to move to better properties; indeed, people should be encouraged to make that move, because the more they do so, the better. Although we welcome the stimulus to the low sector of the market, we also appreciate that people will look to move up the housing ladder, and the tax regime has to be set to allow that to happen.

Gavin Brown: Let us move on to commercial properties. Most of the discussion has been about the 4.5 per cent top rate of tax. How significant is that figure compared to the figure of 4 per cent in the mind of the finance director of a company? That is clearly a factor although, as other members have pointed out, there is a whole range of other factors including the land price, the investment return and the workforce's skill set. How significant will the figure of 4.5 per cent be when investment decisions are made?

John Hamilton: The residential market must also be considered here, because the land aspect of any house building involves a commercial transaction. House building is not set apart from the argument. Broadly, the housing market is being carried by the larger UK house builders because a lot of the market's smaller house builders have, unfortunately, gone out of business over the past five or six years.

I have direct experience of a UK national house builder making a decision about whether to invest in and buy land in West Lothian or Yorkshire. This goes back to the point that Philip Hogg made. The proposals had yet to come through when the decision was being made, and I know that the proposals would potentially impact quite negatively on the chief executive's decision to buy in West Lothian as opposed to Yorkshire. In the commercial area, the tax is a cost, as I said before. A number of large commercial developers operate only in the UK, and they will see a change in the regime in Scotland compared to the regime in the rest of the UK.

More widely, we are encouraging major investment projects including investment in the Edinburgh financial sector. I mentioned the Haymarket project, and projects of that scale run to a cost of tens of millions of pounds. There are other examples of such projects in Glasgow, which has an emerging financial sector. Investment, whether in London, Edinburgh or Glasgow, will be made on the basis of the cost of the transaction. It may be seen as marginal, but it is still a difference in the cost of going through with an investment, and we think that it is more appropriate to consider the issue in terms of the potential loss if some transactions do not proceed. The projects that we are considering, which are valued in tens of millions of pounds, could have thousands of jobs connected to them whether they go ahead in Edinburgh, Glasgow, Aberdeen or Leeds. We think that the stimulation that such projects give to the economy and the number of jobs that they create should be considered directly against the benefit of setting the rate in Scotland at 0.5 per cent above the rate of tax in the rest of the UK.

Gavin Brown: If I understand you aright, the crossover point for commercial property is around £2 million—is that correct?

John Hamilton: Yes.

Gavin Brown: So, if a project is under £2 million, it will pay slightly less tax going forward, but if it is over £2 million it will pay more tax. Is that broadly correct?

John Hamilton: Yes. The threshold is similar to the £325,000 level in residential transactions.

Gavin Brown: I am thinking of businesses from outside Scotland, which operate UK wide or only in the UK, deciding which part of the UK to invest in. What proportion of such inward investment projects would be below the £2 million mark and what proportion would be above the £2 million mark?

John Hamilton: In terms of value, the amount of tax for projects of over £2 million is about 75 per cent of the market value, so that business is being done in an area of proportionally higher value and is being taxed at the full rate. There could be an argument that, in order to attract larger projects to the financial sectors of Edinburgh and Glasgow, we should create a stimulus partly through a process of, if not exactly easing the top rate of tax for larger projects, at least flattening the tax rate at that point so that it would not create an obstacle to investments of that kind, which could generate a lot of jobs.

Gavin Brown: I am grateful for that reply.

The Convener: Can you give an example of the kind of project that could provide thousands of jobs? Also, Gavin Brown asked specifically what proportion of projects—not what proportion of the value—would be over £2 million. I would be grateful if you could answer those two questions.

John Hamilton: I thought that he was talking about value.

The Convener: No, he did not mention value in his question. Your paper clearly refers to 75 per cent of the value, but there could be 10 projects—

Gavin Brown: Let me clarify that I was asking about inward investment as opposed to the number of projects in total.

The Convener: Thanks. There could be 10 projects at £2 million and one at £60 million, and three quarters of the value would be in the £60 million project. I wonder how many such projects we are talking about and how many would provide thousands of jobs.

John Hamilton: I am the chief executive of a development company that sells serviced land to house builders—that is my day job. A typical transaction for serviced land only is valued at £6 million or £8 million, which is the scale at which a house builder will buy land for possibly 150 houses. House builders these days do not pay up front for development land; they pay the landowner or the main developer in instalments, so there is a cost to us in selling the serviced land. I do not have the exact number, but I think that the number of such transactions that will be impacted by the tax will be quite high. A house builder will typically buy land for 100 houses or more, and in most parts of Scotland's housing market that will mean, just for the purchase of land, a transaction value of £4 million to £5 million if not more. That would be a fairly typical transaction value.

The Convener: Thanks.

10:45

Jean Urquhart (Highlands and Islands) (Ind): I have a couple of questions. Mr Hogg, you recommended that there should be a different tax band in what we will call, for the moment, the middle. If we made such a reduction, that would mean a reduction in budgetary terms for the Government. Where would you increase tax to offset that? Would you increase the higher rate or would you change the tax bands for the lower-value properties?

Philip Hogg: As I pointed out a moment ago, without having access to the modelling it is difficult to know what amount would need to be made up if we made that change. We suggest moving the bottom level up from £125,000 to £135,000; however, not knowing what gap we would need to plug, it is difficult for us to know where that might come in.

The other factor to take into consideration is that although, as we have said, taxes can have the effect of stifling activity or transactions, the opposite can be true: taxes can stimulate activity and there can be net contributory effects. I am not an economist, so I am not going to suggest that the number of transactions would increase if we tweaked this or did that. However, that is the sort of thinking that we are talking about.

We genuinely believe that the model is a good move in the right direction. We think that there is a great opportunity for the Scottish Government to see how it could use tax powers to stimulate the economy, and the model is a good first step. We are suggesting refinements to take the model even further, but I cannot suggest what would need to be tweaked by what amount. Our proposal would mean that purchasers of properties valued at above about £400,000 would still pay more than they would under the current system, so we are not suggesting giving them a free ride; we are just asking for the burden to be reduced from what is proposed at the moment.

Jean Urquhart: Where do you think the greatest need is for housing in Scotland today? What is in greatest demand for developers to build? Is it one-bedroom houses? Is it two-bedroom houses?

John Hamilton: That part of the market is probably not being addressed adequately at the moment. As Philip Hogg said, we have built only about half of the Scottish Government target of 30,000 affordable homes, which was set prior to the recession. The industry collapsed to the extent that it was building only 10,000 or 11,000 homes. At that point, the issue became that of who was able to access mortgage funding to buy a property. Generally speaking, it was not the people who were looking to buy one-bedroom flats but middle-income families—growing families with two people in employment and with good credit records—who could continue looking to buy new property. Therefore, that part of the market has stayed up over the past few years and a shortage of choice has been created at the lower end, in the flatted development market.

Mortgage funding is now beginning to ease, and mortgage products are available for the people who were denied mortgages a few years ago. They represent a huge part of the market that has to come back. The registered social landlord sector—housing associations—has partly filled the gap but will not make up the massive 50 or 60 per cent deficit that we have had in the housing market over the past few years.

There must be wider choice. It is critical that we have a wide range of choice for the whole housing market and that artificial barriers are not put in place that lead to people choosing to stay in less valuable property. In order for the whole market to work, there must be trading from the lower end of the market through the middle and into the upper ranges of the market.

Jean Urquhart: Mr Stewart, in your submission you raise the issue of energy efficiency and allowances. What would that look like if it was addressed?

David Stewart: Without presuming to develop a detailed proposal, that would best be done by the Scottish Government in consultation with stakeholders. What we are suggesting is a variation on the tax, whereby people would pay slightly more for properties that are less energy efficient than the average and slightly less for properties that are more energy efficient than the average. We do not propose that that would have a huge impact on the level of the tax; rather, it would send a signal that energy efficiency should be valued, as the Scottish Government has set out in the sustainable housing strategy.

We would be glad to contribute to the development of proposals. We thought that it would make sense, when a buyer was looking at a couple of flats in the same area that were roughly the same value and size, for the taxation system to favour the property that was most energy efficient. Alternatively, if someone was selling a property, there might be a taxation benefit in investing in low-cost energy efficiency measures such as cavity wall insulation or loft insulation, which would make the property more attractive to buyers.

We do not see that as the solution that will hugely increase the energy efficiency of Scotland’s properties; we see it as part of a suite of measures—such as the availability of grant, and the setting and gradual raising of minimum standards—that could help Scotland to work towards meeting its climate change targets.

Jean Urquhart: As the deputy convener said, when we took evidence on the matter, it was felt that it had stopped being an issue; this was not seen as the place to address it. It occurs to me that you are saying that somebody with a less efficient house would pay higher tax and higher fuel bills.

David Stewart: I appreciate that point, and we would have to be careful of that in the design of an incentive. However, the longer-term aim would be that if investment in energy efficiency was incentivised, home owners would pay lower fuel bills. The UK Office for Budget Responsibility predicts that, broadly speaking, fuel bills will rise above inflation for the next 17 years. Even relatively minor investments or incentives to improve the energy efficiency of housing could help to address that issue and, at the same time, reduce carbon emissions.

Jean Urquhart: It seems to me—I do not know whether you agree—that your industry is fairly conservative, with a small “c”, in this respect. Is it lagging behind when it comes to energy efficiency and the difference that it could be making already to the houses that it builds?

David Stewart: I do not agree with that particularly. I would also say—this applies not just to social housing but to all housing—that the great challenge is not so much for new-build housing, for which there are energy efficiency standards to be met, which result broadly in fuel bills being relatively affordable. The great challenge is in existing housing. Our members have the most energy efficient housing by tenure in Scotland. With fuel bills rising, there is always the opportunity to do more.

Often, it is a challenge for our members when they own properties in mixed-tenure stairs, such as traditional tenements in Edinburgh or Glasgow, where they might be the minority owner. They would like to invest in and improve the energy efficiency of the property but they might not be able to persuade either the private owners or a letting agent to participate in increasing energy efficiency. Again, the mechanism that we suggest would help to provide an incentive, along with Scottish Government grants for the private sector; it would push people towards thinking about investing in energy efficiency.

The Convener: I have one or two questions to finish off with. First, I will follow on from Jean Urquhart’s questions to Mr Stewart. We took extensive evidence on the matter in considering the Land and Buildings Transaction Tax (Scotland) Bill, but the issue was that no one could come up with a workable scheme. Mr Stewart said that the Scottish Government should come up with a scheme and that his organisation would contribute to it. The issue is that no one has come forward with such a scheme. The Scottish Government and the committee took the view that the bill was not the place to do that, because it would overtly complicate the issue and there would be other ways of dealing with it.

The question that I want to finish on to round up our discussion has not been touched on, although the matter was discussed extensively during the passage of the bill. I refer to sub-sale relief, on which sections 8.6 and 8.7 of Mr Hamilton’s submission are focused. You are quite critical of what the Scottish Government has come up with. Can you talk us through your views on sub-sale relief?

John Hamilton: As we understand it, the principle of sub-sale relief is still being maintained in the proposals. There are two instances in which it is quite commonplace for sub-sale relief to take place. One of those would be in the example that I gave earlier of a landowner selling a piece of land to a masterplan developer and that masterplan developer then selling the land forward, normally on the same day. The transaction takes places with the original landowner and the land goes through a developer to a house builder

The principle of taxation on the transaction of one parcel of land—it is one item that is being taxed—means that it would be taxed twice in the transactions between the landowner and the masterplan developer, and then between the developer and the house builder. The principle of relaxation from sub-sale relief exists already. We are concerned about getting into a protracted process in which relief on the double stamp, as it used to be called, is obtained. In that situation, the original landowner could be trapped in a process that could take many years before the tax is reclaimed. He is selling his land and the matter of who pays the stamp duty, as it was, or LBTT on that land is not necessarily automatic.

As I said, some of the plots of land can be quite considerable in size and it could take many years to develop them. It would therefore not be easy for a completion certificate to be generated that would allow the tax to be reclaimed.

In a way, we think that it is a problem that does not need solving because it is accepted that the tax has been applied twice and, if both transactions occur on the same day, relief should be granted. In our view, it should be granted promptly and it should be commensurate with the original land transaction.

The Convener: Your submission states:

> “The notion of a relief where tax is paid and might only be refunded at a later date subject to many risks and potential delays is not viable.”

John Hamilton: Yes. The example that I just gave was the case of a large-scale housing development that might take some years to be developed and might involve a number of completion certificates.

The other area that we have a concern about is commercial developments in which forward-sale arrangements are made around a transaction. Again, that involves a piece of land that is bought by a developer and is then improved and developed before being sold on a number of years later. It is not easy to assess when completion would occur in that circumstance, or when a certificate would be available.

We see the definition of the certificate as quite problematic. We think that it is potentially too confusing or, perhaps, that it is an application of a fraught process to what we see as a problem that does not really need to be solved. The industry is not evading tax. Currently, it is paying the correct amount of tax on the transaction. If it is paid twice, and the rules are applied, it is repaid. We think that that situation should continue.

11:00

Philip Hogg: I concur with that point. Our members will recognise the example that John Hamilton has mentioned.

Quite often, there will be a situation in which a lead developer will want to buy a large piece of land from a landowner with the intention not of building on all of the land himself, as it is too large, but of selling parcels of it to smaller developers, and the landowner wants to deal on a one-to-one basis with a lead developer. The system that we understand is being proposed is that the tax would have to be paid up front, but that it could be reclaimed only once the secondary developers had produced completion certificates. That would mean that the lead developer would be taking all the risks and providing all the forward funding of the cash flow and placing all his trust in the sub-developers to keep their part of the arrangement.

Few people predicted the financial crash that we have been through. If, for whatever reason, we were to have another situation in which the sub-developers did not complete their parcels of work and did not build their homes, the lead developer would be out of pocket, through no fault of his own. That risk is clear to our members. It will manifest itself in a wariness on the part of lead developers to take that risk on behalf of someone over whom they have no control. We would seriously ask that consideration be given to the issue.

As John Hamilton said, there is no issue around tax avoidance; it is all about risk and cash flow. We think that the system that is proposed needs to be considered further.

The Convener: Okay, that concludes our questions. Does anyone have a final point to make on any aspect of what we have discussed today?

Ian Honeyman: Basically, the proposal about the new tax and so on is welcomed. It moves things in a direction that will be beneficial to the industry. None of us has access to the modelling for what the tax take will be, so it is difficult to get our heads around the numbers.

Obviously, if the system is to be cost neutral and release a similar amount to what was raised in previous years, the bands will have a significant bearing on that. If the bands were set in a way that delivered a smooth and fair transition across the spectrum, that would be beneficial. The difficulty is that tweaking one end to stimulate the economy has an impact further up the line. However, as I said, we do not have access to the numbers that would allow us to understand the model.

The Convener: Thanks. I call a five-minute suspension.

11:04

Meeting suspended.

11:11

On resuming—

Further Fiscal Devolution

The Convener: The next agenda item is to take evidence on further fiscal devolution. I welcome to the meeting Professor Jim Gallagher, member of Nuffield College, University of Oxford, and visiting professor at the University of Glasgow. Members have copies of a paper from the witness, so we will go straight to questions.

Professor Gallagher, the way things work here, as I am sure they do in most committees, is that I, as convener, will ask opening questions.

Professor Jim Gallagher (University of Oxford): Surely not.

The Convener: Yes. I could just put my feet up and pass it to the deputy convener, but I do not think that that would be appropriate. I will ask some opening questions, trying not to hog all the juicy ones, and then I will open up the session to colleagues' questions.

First, I will quote directly from your paper. On the second page, under the heading "What further devolution is seeking to achieve", you state:

> "The objective of widening the powers of the Scottish Parliament is to enable it to deliver a different combination of taxes and public services from the UK as a whole, while still sustaining the risk sharing benefits of being part of the UK. Increased tax powers play their part in this by giving the Parliament the opportunity to spend more, or less."

You conclude the section by saying:

> "Whatever balance is set must, if the promises made in the campaign are to be kept, be consistent with retaining the Barnett formula."

On the next page, you refer to income tax, which you say

> "is the most obvious tax to devolve ... It is certainly possible to extend that."

Your view is that

> "it would continue to be set by the UK Parliament."

To what extent—for example, rates, bands and thresholds—should income tax be devolved?

Professor Gallagher: That is helpful, convener. Perhaps I should say in introduction that anything that I say here today is purely what I think. I have advised all sorts of people over the years, and none of them is to blame for what I have to say today.

You were right to preface your question by trying to state what the purpose of further devolution is. In my view, the purpose of further devolution is to give this Parliament the range of powers and responsibilities that will enable it to reflect a different set of preferences in Scotland for, among other things, the mixture of taxation and spending; and if Scotland takes a different view from the rest of the UK on that, the Scottish Parliament should be able to implement that in a way that preserves the risk-sharing benefits of being part of the UK, which is important in understanding the nature of the devolution settlement.

The obvious argument for the devolution of income tax is that, first, the Parliament even today has some influence over it, although it has never exercised it; and, secondly, it will be required to set a Scottish rate of income tax under the Calman scheme, with which I was associated. There is certainly scope to go further than that.

11:15

The challenges to going further are as follows. First, income tax is a redistributive tax. It is the only substantial part of the taxation system that is redistributive across income groups. Rich people pay the most of the income tax; I cannot remember whether I quoted the numbers in my evidence, but it is well known that the vast majority of income tax receipts come from higher-rate taxpayers. That means that the tax is redistributive across social groups and is, therefore, also redistributive across geography because rich folk tend to live in one place and less well-off folk tend to live in another. At the moment, when income tax is shared across the UK, the pooling of income tax is redistributive across the UK.

Therefore, the first and most interesting question is whether, over the long run, the complete devolution of income tax would be to Scotland's fiscal benefit. That is the first question that requires to be asked. The view may be taken that it is sufficiently important to devolve income tax that Scotland would be willing to give up any potential upside—or, if there were any, any potential downside—to sharing income tax. However, if it does so, it should do so with its eyes open and with an understanding that what it is doing is ceasing to pool and share that salient element of taxation resource across the entire UK.

The second challenge is more complex and perhaps more amenable to technical solutions, although it would nevertheless require to be addressed properly before a wise Parliament would argue for the complete devolution of income tax. The question is not a partisan question, although it is often presented as such. If income tax is devolved in Scotland, what happens to income tax in the rest of the UK and who makes that decision? Let us use England to mean the rest of the UK—I intend no offence to people in Wales and Northern Ireland, where the principle is the same, by omitting them from this example. If income tax became a Scottish tax, would it also become an English tax? If it was an English tax, which members of Parliament should decide on it and why? Unless that question is properly answered, I do not see that a sensible scheme for the devolution of income tax can be devised.

The third question that requires to be answered is this: what would be the effect on the Barnett formula? Let us imagine, for the sake of argument, that the Barnett formula remained unchanged from what it is today and that income tax was devolved. If the UK Government decided to increase income tax in the UK to spend on a reserved service such as social security, Scots would get the benefit of that tax rise through additional social security payments without paying any contribution. Equally, if the UK Government decided to increase income tax to increase the national health service budget in England, Scotland would get a commensurate benefit in the form of a consequential based on its population share without paying the commensurate tax rise. This is perhaps a technical challenge, but how can one devolve income tax and preserve the Barnett formula as it is currently constructed?

Those are the challenges that would have to be addressed if the whole of income tax were to be devolved, but those challenges do not require to be addressed under the scheme of the Scotland Act 2012, which is due to be implemented in 2016.

The Convener: The UK Government could also raise income tax to spend on Trident, which Scotland might not want.

I do not think that you answered my question, so I will ask it again. Given the caveats that you have introduced, to what extent should income tax be devolved? What is your view on the devolution of rates, bands and thresholds?

Professor Gallagher: Let me deal with rates, bands and thresholds first.

The Convener: Sure.

Professor Gallagher: There is a strong argument for the maintenance of a single definition of income—what constitutes income and what does not—for income tax purposes, not least because that relates to other taxes, such as capital gains tax, but also because it is absolutely critical for the operation of a sensible pension system across the UK.

It is right to say that the threshold at which income tax becomes payable—the personal allowance—should be retained on a UK basis, because it relates very closely to social security benefits and notably to tax credits, which are paid through the income tax system but are, strictly speaking, social security benefits.

To be honest, one can make an argument either way for the variation of the bounds of the higher and top-rate bands. There are arguments in both directions. However, it seems to me that, in any view, one should regard the UK tax rates and bands as the benchmark, because that is the reality of how the financial system works; indeed, that is also the political reality. Subject to that, I would be entirely relaxed about the Scottish Parliament having the power to vary them.

The Convener: Okay. To what extent should income tax be devolved? What is your personal view on that particular issue?

Professor Gallagher: I do not think that the first of the problems that I identified—the lack of sharing and redistribution—can be solved if income tax is devolved. One can simply say that sharing resource is so important and so much in Scotland's interest that not all income tax should be devolved. The argument can go either way on that, but I am personally on the side of going for it, subject only to the other problems that I described being able to be addressed and the way in which income tax is devolved being such that those problems are solved.

The Convener: What about the opportunity to design a more efficient tax system? For example, Her Majesty's Revenue and Customs advised members that some £34 billion or 6.8 per cent of the income tax take was not collected in 2011-12. Is there an opportunity in devolving income tax to develop a more effective and efficient system of collection, given all the difficulties of the UK system?

Professor Gallagher: There is no reason to suppose that a Scottish income tax would be any more or less efficient in addressing its problem of collection than a UK income tax. My view is that it would be entirely unwise to create a separate Scottish collection system and that Scotland should rely on HMRC to do the tax collection for two reasons: the economies of scale and because it is much easier for employers and employees to deal with a single tax authority, as employers have employees in more than one part of the UK and employees might move from one part of the UK to another.

I do not dispute—in fact, I am sure that it is entirely the case—that HMRC could, if it had the resources and the power, collect more of the tax that is due, but there is no reason to assume that devolution to Scotland would make that any more or less likely. Therefore, I favour an integrated tax collection system.

The Convener: If there was a principles-based system, rather than a rules-based system like the system that the UK has, would that be more effective?

Professor Gallagher: I would not claim to be an expert on the different methods of tax collection, but in another part of my life I deal with a principles-based system in the regulation of the financial services industry, and I can tell you that, as a matter of practice, it defaults into a rules-based system.

The Convener: Okay. Let us move on to other taxes. In your submission, you say:

> "A number of other minor taxes might be considered for devolution".

Can you talk us through them? Can you talk us through air passenger duty, inheritance tax, capital gains tax, excise duty and vehicle tax, for example? What are your views on which, if any, of those taxes should be devolved, and why?

Professor Gallagher: There is a perfectly good argument for the devolution of air passenger duty. The Calman commission recommended that. In that context, the only issue that requires to be addressed is whether there is scope for predatory tax competition with the north of England airports. Subject to that, I do not see why air passenger duty should not be devolved.

Excise duties create a problem. As the committee will be aware, Scotland is a big contributor to excise duties, because we smoke and drink too much, but we would face the same difficulty as the UK faces with white vans going back and forward across the Channel—white vans might well go up and down the M74. In respect of excise duties on tobacco and alcohol, there are real avoidance risks whether Scotland taxes more or less.

Personally, I favour the devolution of vehicle excise duty because, although cars move about, registered keepers do not. That is a substantial tax that could be devolved. It is decentralised in some countries such as France, for example. However, there is a price to be paid, which is that owners of fleets of vehicles tend to register in the lowest tax jurisdiction, so some sort of anti-avoidance rule to deal with that problem might have to be devised. However, that excise duty could be devolved.

In principle, I have no difficulty with the devolution of capital gains tax, which is a personal tax very like income tax, but I wonder whether the game is worth the candle, because that tax does not raise very much money and is highly complex. One would think that the same would be true of inheritance tax. International experience suggests that devolution can create distortions, because rich people try to die in the lowest tax jurisdiction, as Australian history shows. The devolution of death duties in Queensland is an interesting example.

The Convener: Thank you.

Under the heading "Financing Welfare Devolution", you talk about devolving individual benefits such as housing benefit and attendance allowance. Will you say more about your thinking as to why some should be devolved and others should not?

Professor Gallagher: I take the view that the deal that the Scottish people signed up to in the referendum campaign was one in which there is social solidarity and risk sharing across the UK. The principal but not only element of risk sharing is the social security system. Therefore, I take the view that the core of the social security system should not be devolved.

Old-age pensions are at the core of the system—they are the largest single benefit—and they certainly should not be devolved. There are good principled reasons for that and, of course, it is in Scotland's interest, because of our differential age structure as projected over the next several decades. It would cost us a lot more, because we will have more old people.

To go back to where I started, there is at least a perception—and it is perhaps the reality—that the Scottish people would be willing to pay more taxes for a more generous welfare system. In principle, there are two ways in which that could be achieved, which takes me on to the substance of welfare devolution before we talk about the financing of it.

One way is to devolve certain individual benefits and enable the Scottish Parliament to take decisions about them. The most obvious one in that context is housing benefit, which is received by most poor people. It is a large benefit that is already administered by local authorities, although it is to be folded into universal credit. In my view, it is entirely possible to devolve that benefit, and it would give the Scottish Parliament real choices about the level of support that poor people receive from the state.

The alternative way is to give the Scottish Parliament power to alter the rates of UK benefits. That could be universal credit or perhaps simply the housing element of universal credit. That approach would have the same net effect as the first way, but it might be administratively easier.

In either event, the fiscal challenge or burden that falls on the Scottish Parliament and that affects the Scottish devolved budget should be the difference between what the UK pays its citizens and what the Scottish Parliament chooses to pay, if it is more. That would avoid the problem of widening the so-called vertical fiscal gap between the Parliament's resources and its budget.

11:30

The Convener: On borrowing powers, you state in your submission that

"a good case can be made that all Scottish government capital spending should be funded by borrowing from the markets, neither subject to the control of nor underwritten by the UK government."

The Scottish Futures Trust said something similar in its paper. Can you elaborate on your thinking in that respect?

Professor Gallagher: Yes. As you will know, the Scottish Government has very limited borrowing powers at present. It has some small capital borrowing powers under the Calman scheme, and a short-term borrowing facility that it has so far never had to use.

I will go back to first principles. The principle to which we are seeking to give effect is that the Scottish Parliament should have the ability to have a bigger or smaller budget if that is what the Scottish people want, subject to the risk-sharing arrangements. Taxation powers have given Scotland that ability in relation to revenue spending, and borrowing powers would give it the capacity in relation to capital spending.

The Scottish Parliament's budget for capital is approximately £3 billion a year. At present, that is financed not by borrowing but directly by the Treasury as part of the block grant. If we are—as we should be—in the borrowing powers business, borrowing should apply to all the Scottish Parliament's capital expenditure. The Scottish Parliament would then bear the interest costs of the Scottish budget, which seems right.

If those borrowing powers are to be widened, that can happen if—and only if—the Parliament's tax powers are widened. If the tax powers are widened, the scope of the Scottish Parliament to borrow, and of course to pay back, should be widened too.

It seems that there is little actual need for the UK to set a cash limit on that borrowing, because the markets will set the limit anyway. The borrowing by the Scottish Parliament should bear a first charge on devolved tax revenue, as legally that is for local authorities at present. The markets will swiftly take a view on how much borrowing it is prudent for the Scottish Parliament or the Scottish Government to undertake.

The Convener: Thank you—that is helpful. I have one last question before I open up the session to colleagues at the table. It concerns proceeding in stages. The Calman process was agreed in December 2007 and the recommendations will not be implemented until 2016, but you are talking about major changes that carry high risks in implementation and should be implemented in a phased way.

Throughout your paper you have mentioned what the people of Scotland voted for, but there is obviously quite a head of steam building up among the electorate in Scotland with regard to ensuring that the proposals that are agreed are implemented sooner rather than later. Can you talk us through that particular aspect of your paper, and tell us what sort of time period you are talking about in relation to phasing in any additional devolved powers?

Professor Gallagher: The challenge in all this is twofold. First, we have not had substantial tax devolution, except in respect of local taxes, since the Parliament was created. The Scottish Government does not as yet have a substantial treasury capability—it has Revenue Scotland, which is a very small organisation. It has yet to learn the skill set for managing a budget that has an income that might go up or down depending on what the economy does, and for dealing with a world in which it has to manage cash flow through borrowing. That is not a criticism, just an expression of how the world is.

Leaping to a situation in which half of the Government's budget is subject to that constraint seems to be quite risky. At present, if we implement the Scotland Act 2012 and the Calman scheme, that will mean that approximately 30 per cent of the Parliament's revenue budget is subject to that kind of challenge. The 2012 act is on schedule to be implemented in 2016, so that seems to be a sensible place to start.

The second constraint is purely electoral. If an Administration is to be formed in this Parliament after an election, it is only reasonable that the people who are being elected to it have a manifesto that says how they are going to use the powers that they have. It is quite neat that, in the 2016 elections, all the parties that are elected to the Scottish Parliament will have to take a view on what they will do with the Scottish income tax.

It is arguable that we should undertake the process in two chunks, in 2016 and 2020. I could be persuaded that it could be done more quickly than that, but the price would be that, halfway through a session of Parliament, big new tax powers would come in and the Administration—whoever it was—would exercise them without necessarily having the manifesto authority to do so.

The Convener: So you are suggesting that any new powers that may be devolved as a result of the Smith commission deliberation should not be implemented in 2016.

Professor Gallagher: You have two choices. One is to go with the 2016 bundle, under the Scotland Act 2012, and implement the Smith proposals after that. The second is to amend the 2016 bundle, in the light of whatever Smith recommends. In either case, it would be prudent to undertake the process in stages.

The Convener: Thank you. I will open up the session now. Michael McMahon will go first, followed by Malcolm Chisholm.

Michael McMahon (Uddingston and Bellshill) (Lab): I will go back to welfare devolution. The convener explored some of the issues, and you commented in your submission on the analogy with Northern Ireland. I will explore that a bit further. Northern Ireland has the principle of parity. Do you support that?

From my reading, it seems that Northern Ireland has for the first time made a change to the welfare system and is refusing to roll out universal credit and implement the bedroom tax. That has led to the UK Government having to provide the Northern Ireland Assembly with a £100 million loan that must be paid back. Is that the type of practical difficulty that could develop in Scotland if we went along with that analogy?

Professor Gallagher: That is a good question, because it illustrates exactly the issue. I understand the Northern Ireland system. For reasons of history, which go back before 1923, the welfare system is devolved in Northern Ireland. The so-called principle of parity is that, as long as the Northern Ireland Administration does exactly what the UK welfare system does, the Treasury will cough up exactly the amount of money that is needed.

In a sense, that principle should underlie any welfare devolution in Scotland—that is, the UK social security net should set a floor and the Scottish Parliament should be able, if it wishes to do so and can raise the money, to supplement that. The only question is whether that money is supplementing the provision of identified benefits, such as housing benefit, or whether there is a general power of supplementation. I can see arguments in either direction.

In Northern Ireland, at least some of the parties in the Administration want to have their cake and eat it. They want to have the devolved power, but they are unwilling to find the money to exercise it. In particular, they—understandably—do not want to implement the bedroom tax, but they are unwilling to make cuts elsewhere in their budget. Of course, they do not have any meaningful tax powers that would enable them to pay for that through taxation. That illustrates the issue neatly.

This Parliament has implemented measures that will—if I have got this right—more or less completely remove the effect of the bedroom tax, but it has taken the hit elsewhere in its spending programmes. Under the proposals that I would support, it would have the choice of taking the hit elsewhere in its spending programmes or increasing its tax income to remove the effect. Does that help you?

Michael McMahon: Yes—that clarifies the position exactly and the options that would be available.

Professor Gallagher: There is no free money in any of this, guys.

Michael McMahon: No—that is the bottom line. We have heard evidence from other experts who have said that we must bear it in mind that bringing devolved powers to Scotland does not necessarily mean that the system will be better or fairer.

Professor Gallagher: No. The constitution is a means to an end: it produces neither more money, nor fairer outcomes, nor a greener country.

Michael McMahon: A minimum wage policy is pursued to create fairness. Do you have any concerns about devolving the setting of a minimum wage?

Professor Gallagher: I favour a UK-wide minimum wage, because there is always a risk of a race to the bottom between one region and another. Were the minimum wage not UK wide, the pressure in the south-east for a higher wage might put Scotland at a disadvantage.

Michael McMahon: That is clear.

Malcolm Chisholm (Edinburgh Northern and Leith) (Lab): I was interested in all of your submission but particularly in page 2, on which you said that the balance of resources from taxation and grants

“should in my view be one of broad equivalence.”

How flexible are you on that? A lot of the discussion is about how much revenue we should be responsible for. You dismissed the idea that we should be responsible for it all. Would you take a hard line on 50 per cent? What about 75 per cent? What would be the objection to that?

Professor Gallagher: There is no magic number, but some numbers are clearly out of order. First, the figure depends on the scale of spending. If the Parliament’s budget was increased substantially for it to take on a new responsibility, it would be a lot harder to get to 75 per cent than it would be if the budget was at its present level.

The principled issue on which we must focus—I am glad that you have raised the matter, because it seems to have been neglected in the Scottish debate—is that, in the United Kingdom, we are in a system in which there is risk sharing and social solidarity. Those apply entirely to reserved services—notably social security—and partly to devolved services. As a principle, the Parliament’s budget should be partly met from resources that are shared across the UK and partly met from resources that are under this institution’s control.

That is entirely common worldwide. Across federal systems, one sees almost without exception the so-called vertical fiscal gap. There are good economic and social reasons for that; it is not simply an accident of history or foot dragging by central Government.

What is the right number? A 90:10 split in either direction would not be right because, were Scotland to be 90 per cent grant funded, the United Kingdom Government would essentially be determining this Parliament’s budget. Conversely, were that figure to be 10 per cent, the public services on which Scots rely would depend almost wholly on Scottish tax revenue, which would be risky and, in the long run, disadvantageous to Scotland.

A split that involves a figure anywhere between 60 and 40 per cent seems reasonable. As a matter of judgment, 75 per cent is pushing it a bit. Were the fiscal transfer from the UK Parliament to be 20 or 30 per cent of this institution’s total budget, it would become swiftly evident that the relative spending lead that Scotland currently enjoys for devolved services was met almost entirely by the grant from the Westminster Government. That would be tactically unwise.

Malcolm Chisholm: You made the interesting point at the end of your submission that the risk from shortfalls is your main concern.

Professor Gallagher: Indeed. We are talking about risk sharing, which includes public services and notably—but not only—health and education services. Services such as those, on which people depend and which are—rightly—regarded as social rights, should not be wholly at risk from long-term or short-term fluctuations in Scottish tax and revenue. That is a question of balance.

Malcolm Chisholm: You mentioned in passing in your submission that

“VAT cannot be devolved, but a share of its yield could be assigned.”

It does not sound as if you have a strong view on that.

11:45

Professor Gallagher: On balance, I am disinclined to assign, but there are people—including some committee members—who take the view that maximising the number of Scotland’s own resources is an objective in itself. If that is regarded as an objective, it could be achieved by assigning a share of VAT revenue.

I will remind you of the risks that are involved in that, because this is all a balance of risk and reward. The risk involved in assigning a share of VAT is that we would take the revenue fluctuations—VAT goes up and down as the economy goes up and down—but we would not have, because we cannot have, any of the tax rate tools to manage those fluctuations. If VAT fell, the Parliament would be unable to increase the rate to increase its income. I would rather give the Parliament a power to rely on a tax that it could influence than have a tax on which it was simply a price taker.

Malcolm Chisholm: Is there an argument for having a mix of taxes? Something that did not occur to me until recently is that, if we had all or a substantial part of income tax but none of VAT, there would be a risk from the UK Government's behaviour. My party has pledged not to increase VAT but, in the past, the Conservative Party has increased VAT in order to keep income tax down. If the UK Parliament raised VAT and cut income tax, would that create a difficulty for the Scottish Parliament? We could not cut income tax without affecting our public services, so Scottish taxpayers would have the disadvantage of having to pay the higher rate of income tax plus the higher rate of VAT.

Professor Gallagher: I do not think that that would be the case, but that depends on the grant mechanism. As it is currently operated and as I would envisage it operating, it would not carry that risk.

There is an interesting question. VAT is a UK tax; it must be a UK tax under EU law, and there are good economic arguments why that should be so, because it is all about tax competition. If VAT were increased, UK tax revenue would increase. That would feed through to this Parliament's share of UK tax revenue through the Barnett formula. It would therefore be open to this Parliament to maintain or decrease its devolved taxes.

Malcolm Chisholm: I am not sure whether that is the case. Surely it is the total tax that matters. The UK Parliament could keep its taxation at the same level but change the balance between VAT and income tax.

Professor Gallagher: Indeed. You are right to raise that point, which I made when I began to talk about the conditions for the devolution of income tax. They include ensuring that the Barnett formula can continue, but appropriately, so that those risks do not emerge. There are ways of doing that, but they would require a bit of algebra, which I cannot write in the air for you.

Malcolm Chisholm: I will move on to welfare and the general power of supplementation, which you illustrated with the example of housing benefit. Are you open minded or positive about that being extended to a wider range of social security benefits, although it will not be extended to pensions?

Professor Gallagher: Yes, in principle. One has to be quite careful and work one's way through the long list. The obvious benefit in this context is universal credit, which is what most people would consider for supplementation.

Benefits can be divided helpfully into two classes: those that are cyclical, which include universal credit, and those that are not cyclical, which include attendance allowance and disability living allowance. It would be easier to devolve the second category into the Scottish budget, because the Scottish budget typically does not include cyclical items.

My preference would be to devolve a big benefit such as housing benefit, because that would enable the Scottish Parliament to play tunes, as it were, particularly in respect of housing. Housing benefit is so big because, in the 1980s, the Government decided to transfer resources from the provision of bricks-and-mortar housing to the provision of cash housing support. The complete devolution of housing benefit would give the Parliament the opportunity to take a different view and say, if it wished to, that for some people, it would be better to provide houses rather than rental support.

On the other hand, I can see the argument that a wider power of supplementation is simpler to operate and would enable the Parliament to say collectively, if the people of Scotland believed it, that it would rather that poor people in our society were better supported and that people who pay taxes paid a bit more tax. If that were the Parliament's policy, it could make that decision.

Malcolm Chisholm: I am sorry; perhaps I misunderstood you. I thought from your paper that you were talking about housing benefit when you went on to talk about the Northern Ireland system. I assumed that you were slightly cagey about having full devolution.

Professor Gallagher: No. I take the view that, if supplementation is gone for, it will involve universal credit—either all of universal credit or the housing element of it. I suppose that, if you were going for supplementation, you should have all of universal credit. I certainly would not take that approach to pensions, because they are a key element of UK social solidarity.

Malcolm Chisholm: There is a traditional argument for devolving housing benefit, which I have supported for a long time. However, shifting the spend to housing supply from housing benefit support would require much more fundamental changes.

Professor Gallagher: Indeed.

Malcolm Chisholm: Could that work with supplementation?

Professor Gallagher: No. It would not work with supplementation, which is an alternative. The idea would involve carving housing benefit out of universal credit, making it the Parliament's responsibility and having a funding arrangement under which the UK guaranteed to provide an annually managed expenditure for what housing benefit would have cost, which is a slightly technical calculation.

The Parliament would then have the opportunity to use that income flow to provide direct cash or bricks and mortar. I do not think that we will move into a world in which we go back to mass provision of housing, because that would cost a great deal more. However, more direct provision of housing would be a much better option for some groups of people who receive housing benefit.

Jamie Hepburn: Your submission seems cautious about the devolution of income tax. However, did I pick you up right when you said to the convener that, subject to some of the issues being ironed out, you are in favour of that devolution?

Professor Gallagher: I said in the submission that there is a list of serious issues that would require to be properly addressed before all income tax could be devolved. To be honest, I think that one of them—the question of redistribution and sharing—is unfixable. I said to the convener that, if the Parliament wanted to argue for the complete devolution of income tax, it should do so with its eyes open and not, to be blunt, simply for ideological reasons, as in saying, "Whatever power we can get, we should grab."

Jamie Hepburn: I got that—it came through in your submission. However, I thought that you said to the convener that you are in favour of the devolution of income tax.

Professor Gallagher: That is if the other issues that I mentioned are addressed. The first is dealing with the problem of English votes for English taxes and the second is retaining and sustaining the Barnett formula in a way that does not unfairly advantage or disadvantage Scotland. I gave the committee examples of how there might be an unfair advantage, but let us think for a moment about the unfair disadvantage.

Let us imagine that income tax was completely devolved but that a United Kingdom Government cut income tax because it had decided that a much better way of providing health services would be to charge 50 quid every time someone visited a general practitioner. In that case, income tax and health spending would go down. The latter going down would reduce the Barnett consequential to the Scottish Government from health spending, but income tax in Scotland would not have gone down. That would be an unacceptable consequence. That set of issues would need to be fixed before income tax could be devolved.

Jamie Hepburn: You said that you think that it would still make sense for HMRC to be the collection body, but you also made the point that there are issues about its capacity to collect, which primarily concern resourcing.

Professor Gallagher: I think that the convener made those points.

Jamie Hepburn: Okay. I thought that you accepted them.

Is it not the case that, because we are dealing with a devolved function, we cannot seek to hold HMRC to account, as it is not a creature of statute that emanated from this place in the way that Revenue Scotland is? Could that be an issue?

Professor Gallagher: If I remember rightly, we addressed that in the Calman commission report. Under the Scotland Act 2012, HMRC collects the Scottish income tax and remits it here. I have not looked at the legislation recently, but I think that there is a line of direct accountability from HMRC for its performance in collecting Scottish income tax in the same way as there is a line of accountability for its collection of UK taxes. I recollect that the revenue commissioners designated one of their number as the Scottish commissioner for that purpose, but I could be wrong about that, as it is a wee while since I looked at the matter.

Jamie Hepburn: I suppose that "accountability" might have been the wrong term to use. What I had in mind was that, if we as a Parliament identified a need for legislative change on tax collection, we could not implement that for HMRC, whereas we could for a devolved body such as Revenue Scotland.

Professor Gallagher: If a tax is devolved completely, as happened with stamp duty, it is possible for the Scottish Parliament to change the structure completely; the Parliament can whip Revenue Scotland if it does not do a good job and can change its powers. My view is that, for the reasons that I explained to the convener, employers and employees benefit from a single UK income tax framework.

The committee might well have taken evidence from representatives of HMRC; if it has, I am sure that they will have made my next point, so forgive me if I repeat it. It is important to remember that income tax is unusual among taxes in that the state does not collect most of it; employers collect it. As any changes to income tax impact heavily on employers, many of which are cross-border employers, maximum coherence in the tax base and tax administration is desirable, if it can be achieved.

Jamie Hepburn: Okay.

Like Michael McMahon, I am a member of the Welfare Reform Committee, which discussed the further devolution of welfare responsibilities at its meeting yesterday. The parity principle that applies in Northern Ireland was well discussed; I will not rehearse those arguments, although I point out that, in his evidence, Professor Spicker felt that, by its very nature, that would not be an appropriate model for devolution here, because he thinks that it would be incompatible with the terms of the Smith commission, which has been set up to deliver substantial devolution.

On a more specific point, Professor Spicker also raised the prospect of this Parliament being able to create new forms of support through the social security system. As you are well aware, that is a reserved matter under the Scotland Act 1998, so we cannot currently do that. He gave the example of the creation of a funeral grant—he was not advocating such a grant; he just posited it as an example—which, at the moment, we would not be able to do. If there were to be some form of devolution of social security—you are talking about the ability to supplement the existing social security system—do you think that it would be sensible for this Parliament to have the leeway to consider other forms of support that are not presently established?

Professor Gallagher: One way of looking at the answer to that question, my reaction to which is not wholly negative, is to realise that support comes in different forms today. The way in which we have divided the welfare state in this country post-devolution is that what would be called redistributive forms of welfare, that is to say, cash benefits, are largely reserved, but distributive forms of welfare—the provision of services—are largely devolved. In all those cases, there is a boundary at which a choice can be made between the provision of a service and the provision of cash.

The Scottish Parliament already has many powers that, in effect, enable it to supplement UK benefits. I will give an example of that before I come back to the detail of your specific point. Attendance allowance is a cash benefit that is intended to enable an elderly person who needs help at home to pay for attendance, whereas the Scottish Parliament already provides personal care free. The principle of allowing this institution to provide supplements is not absolutely wrong. I would not wholly rule out the idea that the supplementation could be in the form of an addition that is not simply an alteration to the rate of an existing benefit.

There are two challenges, however. One is administrative. Creating a whole new bureaucracy for such a measure would obviously be daft. However, the challenge of inviting the Department for Work and Pensions to create a whole new set of beneficiaries only for Scotland might be administratively very expensive for the DWP, and therefore for the Parliament.

The short answer is that that might be conceivable in principle, but it is not wholly straightforward.

12:00

Jamie Hepburn: I observe that, where functions have been devolved thus far, albeit on a very limited basis, the Parliament and the Government have chosen not to go via the DWP; they have primarily worked in partnership with local authorities. There is a model that could work.

Professor Gallagher: Yes, there is. Those powers already exist. Under the Social Work (Scotland) Act 1968, local authorities already have the power to give cash payments in a welfare mode. If you had the money and the imagination, you could probably use those powers in many of the ways in which I suspect you might like to use them.

Jamie Hepburn: I turn to a related issue, referring to something that came up at the Welfare Reform Committee. Mr McMahon has explored this. Perhaps I did not hear you correctly, or I have perhaps written this down wrongly, but I thought that I heard you say that, if the minimum wage were devolved, the pressure for a higher minimum wage in the south-east of England could put Scotland at a disadvantage. I do not understand that.

Professor Gallagher: If there was a geographically variable minimum wage, the economic pressure would be for it to be higher in areas where wages are higher in general.

Jamie Hepburn: Yes.

Professor Gallagher: That is in the south-east.

Jamie Hepburn: But it is already the case that wages are higher there.

Professor Gallagher: That is right.

Jamie Hepburn: I do not understand why that would put us at a disadvantage. Presumably, if the power is devolved, we can set a minimum wage as we see fit for Scottish circumstances.

Professor Gallagher: The economic effects of that are interesting, of course.

I still take the view that there is a risk that a variable minimum wage would mean regional competition in wages in an upward direction. It might not always be you setting the minimum wage.

Jamie Hepburn: It probably never would be.

Professor Gallagher: It might never be.

Jamie Hepburn: That is another point entirely.

I will move on to oil and gas taxation. Although you point out in your written submission that

“oil taxation is, as a natural resource rent, easy in principle to decentralise”—

Professor McLean made that point to this committee, and the Chartered Institute of Taxation has made it to the Treasury Committee down south—you seem to be against doing that. How do other countries of Scotland’s size with significant oil and gas interests—possibly even more significant—cope with that burden?

Professor Gallagher: In other countries, oil taxation is grabbed, as it were, mostly, but not only, as a national resource, rather than a regional one. There are some exceptions to that, however. In some places, the resource is shared between the different levels of Government. Alberta in Canada is an example. There are different ways of dealing with it in Nigeria.

Economic theory pulls us in two different directions. Taxation theory says that we should really tax stuff that does not move around at a sub-national or sub-state level. Oil does not move around, so we should therefore tax it at a sub-state level. That is the argument that the Chartered Institute of Taxation and Professor McLean have made.

The second economic argument points in the opposite direction. You will see that it was explained by the expert group that advised the Calman commission on oil taxation. The argument is that windfall taxes have an inflationary economic effect, which should be spread over a wide area, rather than a narrow one.

However, I do not think that either of those arguments is the basis on which a decision should be made about the devolution of oil taxation in Scotland. The decision is quite a simple one. If your objective is to cut Scottish public spending, you should devolve oil taxation. If your objective is not to cut Scottish public spending, you should reserve oil taxation. Of course, it would be for the Parliament to argue for one choice or the other.

Jamie Hepburn: Given that there are sub-state jurisdictions that have control over their natural resources, and given that there are countries of a similar size to Scotland that seem to cope well with that burden—I use the term “burden” in a somewhat obtuse way, as I do not happen to view oil and gas as a burden—why could Scotland not do so? What is the Scottish exceptionalism here?

Professor Gallagher: The Scottish exceptionalism is quite simple. If your objective is to tie devolved spending to a revenue source that is in long-term decline and therefore puts spending in long-term decline, that is, if I may say so, an ideological rather than a practical view.

Oil and gas revenues hit their peak some years ago. Typically, a good year for oil had £11 billion or £12 billion of revenue, of which probably 85 or 90 per cent fell within what would become Scottish territorial waters. At the moment, oil revenue is around £3 billion a year, with oil prices being low. It is volatile, of course, and it depends on how oil prices go up and down, but it is, on any view, in long-term decline. Let us suppose that we decided today to devolve oil tax revenue, and let us say that it financed £3 billion of the Parliament’s present budget, in 20 years’ time either we would have to find another source of tax revenue equal to £3 billion or we would have to cut this Parliament’s budget by £3 billion. That is just the arithmetic of it. It is not actually an economic question; it is a practical one.

Jamie Hepburn: The point that I am making is that surely the challenge is not unique to Scotland, so what makes us the exception? Why can other jurisdictions manage it and we cannot?

Professor Gallagher: Of course, it is a challenge for the UK. UK oil revenue is declining, and in 20, 30 or even 40 years’ time it will be vanishingly close to zero. The UK is more easily able to manage that, because £3 billion in revenue is a relatively small part of the total UK tax revenues, which are—off the top of my head—£600 billion or £700 billion. However, £3 billion is about 5 per cent of total Scottish spending and 10 per cent of the budget of this Parliament. It is just a question of scale and arithmetic, so I repeat that if your objective is to cut Scottish public spending, by all means tie the budget of this Parliament to oil revenues.

Jean Urquhart: Did you think that devolution was a good idea?

Professor Gallagher: Yes.

Jean Urquhart: Good. When you talk in your paper about full fiscal autonomy and what that means, you state:

“This too is inconsistent with the promises made to the voters”.

What were the promises made to the voters, in your opinion?

Professor Gallagher: Jean Urquhart is right to locate the question of further powers for the Parliament in the wider constitutional space. The promises that were made to the voters during the referendum campaign can be summarised crudely as pensions and Barnett. Let me tell you what I mean by that. They are both questions of social solidarity. The first promise made to the voters was that, if they remained in the UK, they would have the benefit or security of a common social security system with pooled risk, notably in relation to old age pensions, and that stands as a symbol of a principle of social solidarity in respect of what I earlier called redistributive benefits. The second promise was that there would be a Barnett formula, and that stands in the same way as a symbol for saying that there would be social solidarity in the provision of public services, including those public services that are devolved to this Parliament, notably health and education.

As I explained to the convener, my view is that the Parliament's budget should not be solely dependent on Scottish revenues but should be partly dependent on Scottish revenues and partly dependent on a share of UK revenues. That is why, as a matter of principle, the question of full fiscal autonomy—either, as I put it in my paper, in the guise of all public spending in Scotland being determined by Scottish revenues only or in the guise of all the Parliament's budget being funded solely by Scottish revenues—is inconsistent with what was offered to the voters.

Jean Urquhart: Can you suggest any taxes that the Scottish Parliament might ask to have devolved that would allow it to genuinely make a difference? What would be the Scottish Parliament's position in terms of raising taxes that would not affect the Barnett formula and that would not be levelled out as the taxes that are currently devolved are? Other than what you mention in your paper, which is largely about tax, what powers could the Scottish Government be given, in your opinion? Do you have any suggestions of powers that the Scottish Government could take?

Professor Gallagher: Sorry—I am not sure that I follow your question. Do you mean powers other than tax powers?

Jean Urquhart: Or powers to raise taxes other than those that are currently raised across the union.

Professor Gallagher: That is quite a hard question. Let us start with the understanding that the spending powers of the Scottish Parliament are, by international standards, unusually wide. If you look at federal systems worldwide, you will see that the proportion of spending that is devolved to Scotland is higher than the proportion of spending that is devolved to state-level Governments in most federal systems. People tend to blink when I say that, but the data from the Organisation for Economic Co-operation and Development tell us that very clearly. The reason for that is that the Parliament was built on a long history of decentralisation and administrative devolution, and—to go back to your first question—that is one of the reasons why I have always supported devolution. The scope for decentralising additional chunks of spending is therefore, in my view, quite limited. That takes us back to the question of welfare, which seems—to return to my earlier point—to be primarily about UK social solidarity.

Might there be relatively small additional powers? Yes, there might be. I am in favour of finding some way of decentralising at least some of the powers of the Crown Estate Commissioners, for example—to refer to an area that I know you are interested in. As far as taxes are concerned, Governments worldwide are looking for things to tax and have probably found most of the things that can be taxed. If there were more, they would find them. Nevertheless, I think that the Scottish Parliament should have the power to tax additional things if it wants to, subject to such taxation not completely distorting the economy of the rest of the UK.

That is as much as I can say in answer to your question.

Jean Urquhart: One potential tax might be a land tax.

Professor Gallagher: Yes. Of course, that is already within the Parliament's powers.

Jean Urquhart: So, you would see that as—

Professor Gallagher: You have touched on one of my obsessions, so I hope that you have a while. Your earlier evidence session was on stamp duty land tax. Virtually all—all but one—of the taxes that affect real property in Scotland are now devolved to the Scottish Parliament. There are only three such taxes: stamp duty land tax, which is a transaction tax on property; non-domestic rates, which are a tax on the enjoyment of non-domestic property; and council tax, which is a tax on the enjoyment of domestic property. You have them all. The only tax that affects real property that has not been decentralised is capital gains tax on transactions involving property, which is tied up with capital gains tax more generally.

I think that the Scottish Government's proposals on stamp duty land tax are a step forward, but I am disappointed that it did not take the opportunity to look at the taxation of land and property in the round. All those powers are here today, and that seems to have been a wee bit of a failure of imagination. I would move in gradual steps towards a land value tax.

The first thing that I would do is assess the extent to which the existing property taxes approximate to it. Non-domestic rates are not that far away from a land value tax and they are paid every year. Council tax is pretty hopeless; I cannot think how many years it is since anyone revalued. It was in 1991.

12:15

The Convener: It is 23 years.

Professor Gallagher: Thank you. That is quite a while, is it not? There might well be a case for revaluation or another look at council tax. This Parliament already has the powers to look at the taxation of land and real property and it should take a deep breath and think very hard about it. It does not need any new powers to do that.

Jean Urquhart: You do not see any issue with that in terms of the endless debate about not wanting to upset any apple cart by creating competition or movement of business. You cited competition in relation to the minimum wage, although I disagree with you about that, but you have no issue with that here.

Professor Gallagher: Not in relation to land tax, no, because land does not move around.

Jean Urquhart: I was talking about other developments. Our earlier witnesses talked about 0.5 per cent making a difference.

Professor Gallagher: In the long run, taxation on land influences the value of land.

Jean Urquhart: Finally, I want to ask you about the business of tax collection. Your submission refers to national insurance contributions. Collecting national insurance contributions is really just collecting income tax, is it not?

Professor Gallagher: No, for two reasons. National insurance falls into two halves. One is a payroll tax or an employer's tax. I have forgotten the numbers and I do not have them with me, but the committee will have access to them. The payroll tax is one part of it.

Secondly, it is not like income tax because it is not a progressive tax. It is a regressive tax. It is a payment, as it were, for membership of a social security system—

Jean Urquhart: I will stop you there. It is not that I do not understand the basis of calculation of the tax, but where does it end up? People used to imagine that their national insurance went to pay their pension and there was some kind of fund to which they made a contribution.

Professor Gallagher: Well, there is a fund.

Jean Urquhart: But in fact, once collected, regardless of how the taxes are calculated or whether they are contributed by the employer or the employee, the money ends up in the same bucket.

Professor Gallagher: All income tax and national insurance in the end flows into the Treasury because the national insurance fund is not big enough to carry the resources. It is not a funded fund in the same sense as a company pension fund. I could give you a long story about why Lloyd George failed to do that in 1923, but I will not bore you with that.

There are three interesting things to note about national insurance with respect to its potential devolution. First, there is a real principled question about it being a payment for membership of the UK welfare state; it is a gateway into the pension. People still talk about their stamps and whether they have enough stamps to get the full pension. That is important. We ditch the contributory principle at our peril.

Secondly, we could argue that we should decentralise the payroll element or allow it to be varied in some way.

The third element is the percentage element, which is, in a sense, a substitute for income tax. It is now 2 per cent on income above a certain level, which is £40,000 for ever, as it were.

It is also worth remembering—people often forget this about national insurance—that quite a lot of people who have a substantial income do not pay it: most notably, people who are in receipt of pensions.

Jean Urquhart: Do you think that there are areas of tax collection that could be improved generally?

Professor Gallagher: I do not claim to be an expert on that. It is interesting that HMRC can put a number on the amount of tax that it does not collect. I imagine that if it had more resources and more power, it could collect more of it, but I am sure that there would be a trade-off. I do not claim to be an expert on that.

Jean Urquhart: In your enthusiasm for devolution, do you see an opportunity for Scotland to design a different kind of tax collection system?

Professor Gallagher: I gave my view on that earlier. There is a strong argument for a single UK administrative system for income tax, for the benefit of employers and employees.

Gavin Brown: For the record, will you share with the committee your views on corporation tax?

Professor Gallagher: I am not in favour of the devolution of corporation tax, although I can see the argument for it as an economic development tool. I can give you the long reason or the short reason why it should not be devolved. The short reason is to do with Amazon and Google. The trouble with corporation tax is that it is a tax on profits, and profits are not like land. Land does not move, but profits can be moved around at the touch of a button. Companies such as Amazon and Google that route all their profits through low-tax countries are in effect avoiding—perfectly legally but nevertheless irritatingly—a tax that would fall on them. I do not think that it would be in the interests of people in the UK as a whole or, in the long run, of people in Scotland to create such tax competition opportunities inside the UK.

Gavin Brown: In response to the convener's questioning, you said that you are broadly in favour of air passenger duty being devolved, but you had a caveat. I cannot read my writing, but I think that it was something to do with predatory behaviour. Will you expand on what you meant by that?

Professor Gallagher: Absolutely. Newcastle airport in some respects is in competition with airports in Scotland. The worry that people there have is that the Scottish Parliament could take a little bit off air passenger duty, or maybe a lot, and the few flights that Newcastle has managed to get that go outside the UK—I think that it has just secured one to New York—would immediately go to Edinburgh or Glasgow to save the 50 quid or whatever. I have a lot of sympathy with that. That is the essence of the only issue that worries me about the devolution of air passenger duty.

Gavin Brown: I take that point on board. You say that you are in favour of the devolution of APD, but with that caveat. In practice, if you do not want the Scottish Parliament to reduce air passenger duty by a percentage point, how would you devolve it and add in that caveat?

Professor Gallagher: Okay—I understand the question. There are some things that might be done. As you will perhaps know, air passenger duty is already variable across the UK. In essence, the rates vary on the basis of how far away an airport is from Heathrow, and it is already zero in certain parts of Scotland, in the Highlands and Islands.

One possibility is to devolve it on the basis that there was some change in the UK rate that might benefit Newcastle. Another approach would be to do the opposite of what has happened in Ireland and devolve air passenger duty for short-haul rather than long-haul flights. Those are certainly possibilities.

Gavin Brown: Your paper states:

> "VAT cannot be devolved, but a share of its yield could be assigned."

In an earlier answer, you pointed out the risks of so doing. However, on balance, do you have a view on whether VAT should be assigned in part or in full?

Professor Gallagher: As part of an overall package, I would probably sign up to the assignment of a number of percentage points of VAT. I would just be careful, in the interests of this institution and the people of Scotland, not to take on too much risk. I would be cautious—I certainly would not go above 10 per cent and I might suggest going below that.

Gavin Brown: My final question is on a more theoretical issue. Malcolm Chisholm asked about the "broad equivalence" that you mention in your paper, and you gave the useful answer that it had to be either 50:50 or 60:40—those were the ends of the spectrum

Professor Gallagher: Yes—it should be somewhere around there.

Gavin Brown: From a theoretical point of view, a number of witnesses have said that we should look carefully at that because, whether the figure is 50, 40 or 60, some of it will be made up of tax that is truly devolved, some could be made up of tax that is partially devolved and some may well involve assignation, where we have to share the risk but we cannot control the rates.

Those witnesses were saying that there is an extra dimension that we have to think about instead of just looking at the pure percentage. You mentioned the OECD, and they said that although we might think that there is a lot of control in Germany, for example, there is not much control over the rates.

Do you have a view on how that 50:50 split should be made up? If it was theoretically made up only of taxes that were assigned and none that were devolved, that would be different from—

Professor Gallagher: I certainly would not buy that deal.

Gavin Brown: It would be different from having 50 per cent devolved taxes. Do you have a view on the balance that there should be? How ought we to weigh that up?

Professor Gallagher: That is quite an interesting question. I agree that pure assignment is all risk and no power. If VAT is assigned, your revenue goes up and down, and—short of long-term investment to build the Scottish economy—there is not a lot that you can do about it. Therefore, a deal that is pure assignment would be the purest presentation and I would not recommend it.

I can understand why people take the view—although it is a slightly superficial view—that the number really matters and that we should therefore put in some assignment to get to that number. I can genuinely see the presentational argument for that. In the end, my view on the 50:50 or 60:40 question is really about the amount of risk that you import. I would be unhappy with importing 75 per cent risk into the budget, particularly as the only way I can see of importing that would involve a lot of assignment, which may put additional powers at risk.

Conversely, I entirely accept that the Parliament raising 25 per cent of its own resources does not really give it the power to do what I think the objective of all this is. While Scotland remains inside the UK, with the risk-sharing benefits—and, indeed, the economic benefits—that that brings, the Parliament should nevertheless be given the opportunity to reflect a different approach to public services and taxation, if that is what the people of Scotland want.

Only by experimenting will you find out if that is indeed what the people of Scotland want, because it is very easy to be in favour of increased public spending when you know that you are not going to pay any increased taxes or have to make the choice to increase taxes. It would be good for the Parliament and for the people of Scotland to have that choice and then make it one way or another. I am not sure what choice they would make—you will have to try it and see. Is that helpful?

Gavin Brown: That is helpful.

John Mason: Thank you, Professor Gallagher, for persisting through all this.

Professor Gallagher: It is nice to see you again.

John Mason: In the introductory remarks in your submission, you talk quite a lot about different kinds of union—political and economic—and about respecting the outcome of the vote. I am not entirely clear about why different people voted no—or yes, for that matter. I will concentrate on the no side. One or two people do not even want the Scottish Parliament to be here, so they voted no; some people want things to carry on as they are, so they voted no; some people want a little bit more power; and some people want a lot more power. It is quite difficult within that mix, is it not, to discern what the public want?

Professor Gallagher: It was not my idea to have a referendum. You got a result and that result was that you remain inside the UK. The best way of answering your question is to look at what the campaigners offered, but, in the end, who knows why people vote a certain way? Voters are a bit like students—they like to answer the question that they wish they had been asked. Lots of people voted yes for reasons other than the question on the exam paper. We know that from other referendums, such as those on the European constitution in France and Ireland, where people answered a different question from the one that was asked. That is one of the risks of having a referendum. Nevertheless, the question was asked, and it has now been answered.

If you look at the promises and commitments that were made about what people would get if they voted no, it is perfectly plain that, by definition, they were voting for a political union; in my view, they were voting for having equal Scottish representation in the Parliament at Westminster.

John Mason: Could you expand on what you mean by "equal"? It could mean that we get 50 per cent and England gets 50 per cent, or it could mean something else.

12:30

Professor Gallagher: I am a Chartist in this respect. I think that everyone's vote should have an equal effect—

John Mason: By the person—

Professor Gallagher: —in electoral districts. At the moment, we have almost got that. By an accident of history, Scotland is slightly overrepresented in Westminster.

When people said that they wanted to remain part of the UK, the presenting question was one of political union. Political union is linked to two other forms of union, both of which were heavily debated during the campaign. The first is what I would call economic union, and the big symbolic issue in the campaign concerned whether we would have a single currency after independence. It seems to me that the argument was made and accepted that the maintenance of a single currency outside of a political union was, at best, perilous. It therefore seems to me that the voters have voted for an economic union.

It also seems to me—

John Mason: I am sorry to interrupt, but would you accept that there is a range in there? Clearly, you either have a single currency or you do not, but, with regard to the word "union", you are either more united or you are less united, but you are probably never completely one union or completely not one union.

Professor Gallagher: There are a number of ways of analysing the concept of union.

I am going to sound a bit professor-like for a moment, but the academic literature on the subject shows that there is quite a well-defined concept of a union state, which is a state that has been formed by the union of pre-existing countries but which retains in its form some of the institutional inheritance of those pre-existing countries.

The union between Scotland and England in 1707 is precisely of that kind. Although that was a political union, through the creation of a single Parliament, something was maintained that actually mattered more to most people than the Parliament, which was a separate church. There was also a separate legal system, which was, at the time, the only domestic instrument of the state. That is the form of union state that we have, and have always had, in the United Kingdom. Scotland has always had a separate, distinct and continuing institutional identity. That was not invented in 1998 when this Parliament was created. What this Parliament did was give that institutional identity and that historical continuity a democratic aspect that was wholly appropriate in the 20th century—it was perhaps appropriate in the 19th century, but was clearly not relevant in the 16th, 17th or, indeed, 18th centuries.

That is one way of looking at union. The other involves the respects in which the union operates. One respect is political. The second is economic, and the nature of the economic union is, essentially, a single domestic market—free trade. That is what people were after in 1707.

The Scots were in trouble in 1707 for two reasons. One is that they were bankrupted because of the Darien scheme, and the other is that they were being frozen out of English markets by tariffs. The union in 1707 created what the Europeans would call a single market, and what has been created since then is a domestic market. Capital, goods, labour, investment and trade all flow across the Scottish-English border without any let or hindrance. There is a real contrast between that and the European market. That is what makes a single currency sustainable, along with the fiscal framework that involves a sharing of resources. That sharing of resources is economically necessary.

A fiscal union is necessary to make a currency union work and it is also what gives effect to the third aspect of union, which is the social aspect. That involves social solidarity and the sharing of resources, first and foremost in relation to pensions and benefits and so on, but also in relation to the securing of common social rights such as health and education through a funding system that enables this Parliament to do that, even if Scottish tax revenue falls through the floor.

John Mason: On your final point about social union, there is again a range of meanings there. As we have said, there are already differences in relation to personal care, free home care and so on, which means that the systems are not exactly the same across the union. Do you think that, if people voted for the social union, they were saying that, for all time, their pensions should be the same as those down south, or do you think that they were actually worried that their pensions might be poorer than those down south and that they would have been quite happy if their pensions were better here?

Professor Gallagher: They might be happier in that circumstance, but the question is counterfactual and I do not have the answer to it. However, if one looks at the voting patterns, it is pretty plain that, of all the issues that were around during the campaign, securing a continued UK pensions system was pretty near the top of the agenda. If you ask somebody whether they would like a bigger pension, they would probably say yes, and if you ask them whether they would like it to be less, the answer would probably be no. As a matter of pragmatism, if you look at the age structure of the Scottish population, you will see that it is prudent to pool that risk at a UK level.

John Mason: At the moment, social protection—that is, pensions and benefits together—represents much the same proportion of tax income or gross domestic product in Scotland as it does in England and Wales. Therefore, at the moment, there is really no pooling going on. Are you arguing that there is a risk in future, which is why we want to be able to pool the risk?

Professor Gallagher: If I may say so, that goes back to Mr Hepburn's question. The point that you make is true only if you include in the GDP the offshore numbers and, of course, those offshore numbers have two characteristics: as a proportion of GDP, they produce a lot less tax than the rest of GDP, and they are going to decline over the long term. Therefore, I think that the comparison that you make is the wrong one.

John Mason: When you say that they are going to decline, you are assuming that the oil price will not go up dramatically.

Professor Gallagher: No, I am assuming that, at some point, a finite resource will come to zero. Oil will run out one day—unless, perhaps, you think that it will not.

John Mason: Well, I think that there is more to find under the Atlantic, but that is a separate question.

Professor Gallagher: That is undoubtedly true, but do you think that it is infinite?

John Mason: I do not think that anyone is suggesting that.

Professor Gallagher: Good—that is progress.

John Mason: However, we have the answer to that in renewables.

Professor Gallagher: Oh, come, come.

John Mason: We will not go into that just now.

Let us stick with the social union. In your submission, you say that

"NI contributions provide a gateway to the welfare system".

I know that we have touched on this already, but is that not a bit of an outdated concept? You used the word "stamp", which is relevant to my age group and above, but not to 20-year-olds.

Professor Gallagher: Perhaps; nevertheless, the contributory principle is an important one, for two reasons. One is that it demonstrates to people that they are buying into a system of common and shared risk, and the other is that it is, if you like, a fee for membership of the welfare state.

If you look at the history of the welfare state, you will see that Beveridge very much wanted to minimise the idea of a set of people who constantly receive support from general taxation. That might sound a little outdated these days, but his aim was that most social security should be funded by a kind of common pooling of resources that would be a bit like an insurance system—which is why Lloyd George called it national insurance—and that there would be a principle of putting in and taking out. I think that we have lost rather too much of that. We should have more of the contributory principle, rather than less.

John Mason: You could argue that that is the way in which the tax system is applied.

For a long time, it has been suggested that tax—pay as you earn—and national insurance should be put together at a UK level. Presumably, if both elements were devolved to Scotland, we could put them together and create a simpler system that would cost a lot less to administer.

Professor Gallagher: There is a difference between understanding the nature of a single administrative system and understanding the nature of the taxes. In one sense, the administration system is neither here nor there. In principle, it would be entirely possible for the UK to invite HMRC to administer the national insurance system in an integrated way with the tax system. That is not the same as saying that you would simply pool the two taxes and have a single tax rate. I go back to what I said earlier: the contributory principle, which is regressive in terms of income, is, nevertheless, important. If you accept my argument that, when income tax is devolved, there should be a single system of administering it across the UK, those opportunities would still remain.

John Mason: Okay. With regard to benefits, which we have touched on a bit, I think that you have suggested that the Scottish Parliament could supplement benefits.

Professor Gallagher: Yes.

John Mason: Two of the key problems that we currently face are sanctions and work capability assessments. Some of us feel that people's benefits are being stopped for reasons that are not good and that some people are being assessed as fit for work, even though they are not. We could not deal with such issues with just a supplementary system, because that would require a change in the fundamental way in which the DWP works.

Professor Gallagher: I do not know the answer to that, Mr Mason, because I have not studied the issue. You might be right, but I would like to think about that question before I answered it.

John Mason: My fundamental question is: do we just want to top up the current system or do we really want to change it? Many of us would like to change it.

Professor Gallagher: Of course, many people would like to change the current system at the UK level, too.

John Mason: Yes. Is that not likely to happen?

Professor Gallagher: I do not know. Can you tell me the result of the next election?

John Mason: Okay. That is fine.

I have a couple more questions. We have talked about housing grants versus housing benefit, and I think that you talked about supporting the capital building of houses or paying people cash to pay perhaps a higher rent. Currently, we are a bit unbalanced in that respect, because we are trying to support the building of houses. I presume that that will bring down the housing benefit bill, but that is a Westminster thing. Would joining up the two issues make sense?

Professor Gallagher: I am not quite sure that I share all the premises, but in principle the argument for devolving housing benefit as opposed to having a supplementary system is to enable the transfer of resources between capital and revenue. That is the argument of principle and why I have suggested the devolution of housing benefit. A supplementary system will give you most, but not all, the upside of that approach. You will not get all of it, because you cannot play such tunes, as it were, at the edge between capital and revenue support.

It is worth remembering that it is very easy in these conversations to assume that, if we just devolve, there will be more of everything and that everything will be better. When, in the 1980s, the Conservative Government moved from supporting investment in public sector housing to supporting individuals through housing benefit, it saved money. Indeed, that is one of the reasons why it did so. The housing programme was substantially cut, and although the housing benefit line went up, it did not go up by as much as the programme line went down. Consequently, you should not be fooled into thinking that, if these things were simply devolved, lots more resources would become available. They would not; you would just be able to move the resources relatively at the margins—

John Mason: When the Conservatives took that decision, did they make a short-term saving, or was there also a long-term saving? I presume that the capital was saved in the short term, but that more benefits were paid for quite a long time.

Professor Gallagher: The benefits ran on over time. However, that was baked into the baseline, and, indeed, the Scottish Parliament's budget reflects that ancient historic baseline.

John Mason: My final question brings us back to the minimum wage. I am not sure that I quite understood the argument about London having a higher minimum wage. Were you suggesting that many of our people would go to London to work?

Professor Gallagher: My objection is slightly more general than that and brings me back to my economic union argument. There are certain guarantees from being in the United Kingdom, and it seems to me that the minimum wage is rather a good one. I am worried about the idea of different regional minimum wages in the UK because of the risk of a race to the bottom.

John Mason: What if it was the other way round and Labour and the Scottish National Party desired to put the minimum wage immediately at the level of the living wage, which I think is £7.85 an hour or thereabouts? Would things not be the other way round?

Professor Gallagher: Yes, but one of the tricks in designing constitutional systems is to ensure that they are proofed against any politician who might be in charge, not just the nice ones.

John Mason: The Conservatives? Right. Okay. Thank you.

The Convener: Aye, because they are going to have the levers of power in Scotland in the foreseeable future. I was going to touch on the same issue, but I think we have had enough on that for the moment.

That concludes the committee's questions, but I would like to touch on one or two wee things to finish off. When I asked for your views on devolving a number of taxes, you mentioned inheritance tax and APD when you were rhyming them off, but I do not think that you touched on capital gains tax. What are your views on devolving that tax? Would you support that?

Professor Gallagher: I think that, as a matter of principle, it would possible to devolve that tax; I just wonder whether it would be worth all the bother. Capital gains tax has a very small yield; I do not have the number at the front of my mind, but I think that it is about £100 million. I see that Gavin Brown is looking for the figure.

Gavin Brown: It is £292 million.

12:45

Professor Gallagher: Thank you very much. To devolve that tax would be quite disruptive. Few people pay it, and most of those who do use smart tax management schemes, because they are using up their capital gains allowance rather than their income. If you like, you can look at payment of capital gains as a way of minimising income tax.

I would worry a little bit about the risk of avoidance. I would not rule out the devolution of capital gains tax as a matter of principle but, to be frank, I wonder whether it is worth the bother.

The Convener: Thank you for that.

Finally, on the Scottish rate of income tax, should the annual indexation of the block grant adjustment take into account population growth at a UK level relative to Scotland?

Professor Gallagher: First, things might be different if one went for a system that involved the whole devolution of income tax or the assignment of all income tax processes. As a result, what I have to say relates only to the scheme in the Scotland Act 2012. That is important, because different considerations apply in different circumstances.

Under that scheme, there are various risks in what you might call the revenue stream to the Scottish Parliament, some of which should be allocated to this Parliament and some to the United Kingdom Parliament. This Parliament should primarily bear the risk of its own taxation decision; in other words, if it cuts the tax it gets less money, and if it increases the tax, it gets more. Secondly—and this is the easy one—the United Kingdom Parliament should bear the risk of any changes to the tax base's structure. In other words, if the UK changes the personal allowance, it should make a compensating change to the Barnett formula grant one way or another.

Those two scenarios are relatively straightforward. The interesting one, which is the one that you have suggested, convener, is about relative growth in the tax base. That might happen as a result of growth in relative population or income—the cause does not matter—but in any case this Parliament should bear the risk. After all, greater fiscal autonomy is exactly what you and some of your colleagues are arguing for. That is right in principle both in this case and certainly in the case of the Scotland Act 2012, because it gives the Scottish Parliament the benefit of the upside of greater growth in the Scottish economy and incentivises it to ensure that that happens and that it uses its powers in that way.

As for the own resources element under the Scotland Act 2012, this Parliament should bear the risk—both the upside and the downside—of relative growth in Scottish income tax compared to English income tax. If that does not happen, the act is not doing what we had intended it to do.

The Convener: Indeed, but what if the population of England were to grow at a higher rate than that of Scotland? As you will probably know, the recent per capita figures show that there has not been much GDP growth. A lot of the growth has happened because of the increase in population.

Professor Gallagher: Oh yes—absolutely.

The Convener: If England's population continues to grow, will that disadvantage Scotland in relation to the block grant adjustment?

Professor Gallagher: It depends what you mean by "disadvantage". For a long period, England's population has grown more than that of Scotland's, primarily because it has had a lot more immigration than we have had. You are absolutely right to suggest that when people say that Scotland's growth has lagged behind the rest of the UK and that things are bad here, they are talking nonsense. For many decades now, Scotland's GDP growth has been higher per head than the UK; indeed, that has been the case since the numbers were calculated in 1968.

The Convener: And that is because its population has gone up.

Professor Gallagher: That is right. The English population has gone up but, as far as growth is concerned, the GDP per head in Scotland has exceeded GDP per head in England. I do not think that relative population growth is either a good or a bad thing—it is just what it is.

We should not use the income tax system to say that, because England's population is growing, they should send us more money. Relative population growth in the income tax base is part of the driver of relative population growth in the income tax yield, and the Scottish Parliament and its budget should bear that risk relative to England.

The Convener: Okay. You have clearly made that point. Thank you very much for your straightforward answers.

Professor Gallagher: It was a pleasure.

The Convener: We have kept you for 100 minutes already, but do you have any final points?

Professor Gallagher: Thank you, convener. It is good to have been here. We are in a very interesting period. As Ms Urquhart and I were saying, we are in a time when we have an opportunity to create a long-term, stable and well-functioning devolution settlement for this Parliament, but we will do that if—and only if—we address the questions on their merits. I hope that that is what I have been doing, and I am sure that the committee, too, will do the same when it reports on the matter.

The Convener: Thank you very much. As that was the last item on the agenda, I close the meeting.

Meeting closed at 12:50.

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