



The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

FINANCE COMMITTEE

Wednesday 19 November 2014

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FINANCE COMMITTEE
29th 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 Anton Muscatelli (University of Glasgow)

Ben Thomson (Campaign for Scottish Home Rule)

Professor Alan Trench

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance Committee

Wednesday 19 November 2014

[The Convener opened the meeting at 10:00]

Decision on Taking Business in Private

The Convener (Kenneth Gibson): Good morning and welcome to the 29th meeting in 2014 of the Finance Committee of the Scottish Parliament. I ask everyone present to turn off mobile phones and other electronic devices.

Our first item of business is to decide whether to consider items 3 and 4 in private, and whether to consider draft reports on the draft budget 2015-16 and our inquiry into further fiscal devolution in private at future meetings. Are members agreed?

Members indicated agreement.

Further Fiscal Devolution

10:01

The Convener: Our next item of business is to take evidence on further fiscal devolution. The item will consist of two separate evidence sessions, starting with Professor Anton Muscatelli, who is principal and vice-chancellor of the University of Glasgow. Members have copies of Professor Muscatelli's written submission.

We will go straight to questions from the committee; I am sure that Professor Muscatelli knows the drill. I will ask the opening questions and then open up the session to colleagues round the table. I emphasise that Professor Muscatelli has made it clear in his paper that he is speaking in a personal capacity and not as the principal of the University of Glasgow.

Professor Muscatelli, you have stated that "there is no single 'correct' answer to the degree of devolution which should be implemented",

as

"it depends on the balance of public opinion in Scotland."

You highlight three principles that you say

"could be used to analyse a financial framework",

and they are

"Equity ... Efficiency and Accountability".

You go on to discuss

"major differences in political preferences and social attitudes"

and the

"vertically imbalanced fiscal systems amongst the OECD economies",

of which the United Kingdom is one of the most obvious examples.

Let us look at some of the powers that could or should be devolved. One that you mention is income tax. You say that

"income taxation devolution presents the least difficulties",

and that

"Further ... control over tax bands and thresholds would be a further evolution of the current system."

Why would partial devolution of income tax be suboptimal, and complete income tax devolution optimal?

Professor Anton Muscatelli (University of Glasgow): Full devolution of income tax is the most obvious solution because it is, in a sense, the tool that is used most often in devolved systems. It offers less of a basis for tax competition within the country. There are around

the world systems in which income tax is a devolved tax; we can see that it is less likely to create difficulties with regard to deciding how the tax should be imposed and what the tax base is.

Scotland has already adopted a system under the Scotland Act 2012 whereby it will, in due course, have some power over income taxation, although—as I point out in the paper—it will account for only about 17 per cent of the total spend in Scotland. At present, given how it is designed in the 2012 act, it will essentially be almost a flat tax that will superimpose itself on the United Kingdom system. Once you have that mechanism in place and the instruments to implement it, it is not a huge jump to say that you could devolve allowances, thresholds and bands, which would be simply an evolution of that system.

As I point out in the paper, income taxation in 2012-13 made up approximately £10.8 billion of the total revenue that can be attributed to Scotland. If you want to address the vertical imbalance that I mentioned to allow for more accountability, the only real way to do that is by looking at major elements of taxation, of which income tax is the most obvious one.

It is therefore not surprising that all the proposals to the Smith commission, whether from political parties or from independent think tanks, identify income tax as the most obvious element. It is already being implemented, it is substantial and it offers less of an issue in terms of tax competition. It should be devolvable in its entirety if that is the wish.

The Convener: In your paper, you also state:

“people choose their location not only on the basis of tax considerations but also on the basis of the public goods offered.”

Can you talk a wee bit more about that? Some witnesses have suggested that significant tax differences between Scotland and the rest of the United Kingdom may impact on people's residence choices. Is there a tipping point at 3 per cent, 5 per cent or whatever? Obviously each individual is different, but is there a rule of thumb as to where the difference becomes significant?

Professor Muscatelli: There is no fixed rule of thumb. Jurisdictions learn to operate within the limits. Even in countries that are very small geographical areas, such as Denmark, there are income tax variations among local authorities. One might think that it would be easy for people to avoid taxes by moving around, but the reality is that they do not, and local authorities discipline themselves in order to avoid introducing huge differences.

To be honest, I do not see that as much of a problem. I expect that if the whole of income

taxation was devolved with full powers over tax bands Parliament would find the equilibrium.

As you mentioned, I point out in my written evidence that people choose their location not simply because of the tax regime that is in place. They look at the public-good offering, and they consider whether they would prefer to be in a place where there is slightly higher taxation and better spending on health and education. It is a personal choice, and there are no hard and fast rules. We know that migration is not hugely sensitive even to wage differentials, so one would not expect it to be sensitive to disposable income differentials across a country such as the UK. I do not think that it is an issue, but clearly the jurisdiction itself would need to find the right balance between the variables.

The Convener: What if Scotland had control over the minimum wage? Previous witnesses have suggested that Scotland having control over that lever could create in the UK differentials that could lead to a race to the bottom. Is that likely?

Professor Muscatelli: That is an interesting question. To go back to the debates among economists and policy makers when the minimum wage was introduced, everybody thought that it would have a huge impact on employment and that it would disrupt labour markets. The reality is that it has not done that at all; it has not reduced employment. In fact, if anything, it has helped to support incomes in the lowest range of income distribution.

I do not think that what you describe would lead to a race to the bottom. It would be interesting to see, if Scotland had powers over the minimum wage, whether it would decide to raise it or to adopt something more akin to the living wage and align the minimum wage with that. Would that really create a race to the bottom, and would we see many companies moving? I suspect that we would not. Mobile jobs tend to be high-skilled jobs and would not fall in the range on which the minimum wage would have an impact. I think that the minimum wage is the sort of lever that could be devolved.

The Convener: You state:

“as noted by the Holtham Commission ... there may be good reasons from the point of view of economic development, job creation and encouraging growth why corporation taxes and other linked instruments like R&D tax credits might be looked at for possible devolution.”

What would be the benefit of devolving those areas?

Professor Muscatelli: The benefit would be that those things could be used for employment creation. The independent expert group that I chaired looked at that in the context of the previous discussions on devolution. We thought at

the time that the tax competition issues were potentially problematic, but the Holtham commission came up with quite a neat solution that might, on reflection, be the way forward. It concerns how corporation tax might be allocated to different jurisdictions in the UK and might depend on real economic activity, such as employment. That could be a useful device.

The usual argument against devolving corporation tax is that companies can set up brass-plate operations, they can use transfer pricing, and that they will pretty much just allocate profits wherever they like around the country. Work within the country to allocate tax on different bases, for example employment, might address that criticism and might allow corporation tax to be devolved.

As I say, the main reason for devolving corporation tax is to provide levers for jurisdictions like Scotland to deal with the slightly unbalanced nature of economic growth in the UK, in which London is growing very rapidly. Devolution of corporation tax powers to Scotland and Wales might provide a lever for economic development.

The Convener: I am very interested in that point. You said in your submission:

“any differential rates within the UK would need to be linked to, say, employment levels.”

You have just touched on that point. How do you envisage that working in practice?

Professor Muscatelli: The details would need to be worked out between the UK and Scottish Governments and any other devolved jurisdictions—Wales or others—that might be given that power. It could be done in various ways. There could be an overarching agreement on how corporation tax operates at UK level, but the tax could be allocated among the jurisdictions—say, on the basis of how many employees a company has there. A company might owe £X of corporation tax overall, taking the aggregate across the jurisdictions, and how that amount was allocated could depend on how many employees it has in Scotland relative to how many it has in the other parts of the UK, or it could be based on other elements.

If the allocation were to be done on the basis of profit—in the way that corporation tax is normally allocated across international jurisdictions—that would present a difficulty and would simply lead to brass-plate operations. If the UK system was based on tax agreements between the UK jurisdiction and Scotland, Wales and wherever else, and they were given some powers over corporation tax, it would be possible to work out a mechanism for allocating such taxes.

The Convener: On borrowing, you mention the need

“to deal with asymmetric macroeconomic shocks which temporarily affect tax revenues in devolved administrations.”

You call for

“Appropriately extended borrowing powers”,

which you say

“would be able to allow each devolved part of the UK to smooth out temporary shocks.”

Are you suggesting that such borrowing should be allocated for revenue spending, rather than for capital investment, for example?

Professor Muscatelli: It would be very difficult not to have some sort of smoothing mechanism. You would have to do that, whether through borrowing or through an agreement on the extent to which there can be a difference between spending and taxation decisions.

Suppose that income tax and corporation tax are devolved, and that you assign some other taxes such as VAT. There would be volatility from year to year in tax receipts, and you could not simply require Governments to adapt their revenue spending year to year. That would not be a sensible arrangement. One solution would be to have borrowing powers for that, which would be managed through some sort of stability pact within the UK.

If Scotland had borrowing powers it might be given a deficit ceiling, or there might be some sort of deficit rule that it would need to maintain over the cycle in a way that was consistent with the UK's macroeconomic framework. That would be one way of doing it.

The other way of doing it would be through some sort of reserve. In years of high levels of taxes relative to spend, it would be possible to put money into that reserve, but it could also be drawn on. That could be done either through direct borrowing by Scotland or through some sort of reserve within the UK.

The Convener: Your submission discusses excise duties, fuel duty, tobacco duty, alcohol duty and so on. Could or should inheritance tax and capital gains tax be devolved?

Professor Muscatelli: Those are interesting issues. You would need to find a suitable way of assigning inheritance tax because it would be easy to avoid that tax. It could be done based on residency but, even in the UK, there are issues around domicile that impact on inheritance tax. The question whether it would really be possible to divide inheritance tax by location would need to be examined in quite a bit of detail.

Once you start devolving the whole of income taxation and other big elements of taxation, you can devolve capital gains tax. It would move you from where you are with the Scotland Act 2012, by which you are mainly managing the Scottish rate of income taxation through a Scottish tax code, to a situation in which you would need to ensure that tax returns were appropriately labelled by residency. So, if I was a Scottish resident and I incurred capital gains taxation, Her Majesty's Revenue and Customs would need to be mandated in order to make it clear that my capital gains taxes would go to Scotland because I was a Scottish resident. You would need to get those rules absolutely crystal clear, but there is no reason why you could not devolve capital gains tax.

10:15

Inheritance tax is more interesting. Again, devolving it is potentially doable, but it would be subject to avoidance because people would simply move if the rates were different in different parts of the UK. People would manage their affairs by moving around to avoid paying a higher rate.

The Convener: Do you think that HMRC should continue to be the agency for tax collection in Scotland? How far should control of tax gathering be devolved?

Professor Muscatelli: I am not an expert on HMRC, but it would be sensible for one agency to do the job on behalf of the devolved areas of the UK. It would need to be done on the basis that the agency would not work according to a hierarchy whereby it would largely serve the UK, then offer a service at a cost to the devolved authorities. If you start devolving income taxation and a wider range of taxes, for that full range of devolution the agency would need to serve both Parliaments. That could be done and there would be efficiencies in keeping a single agency that would serve two jurisdictions. We see it being done in other countries, so I cannot see why that, as opposed to having the costs of setting up an ex novo agency, would not happen in the UK.

The Convener: Thank you. I have a final question before I open up the session to colleagues around the table. On your three principles—equity, efficiency and accountability—you say in your written submission that

“no set of tax devolution arrangements achieves an optimal outcome”.

Moving away from pure economics to what you said initially in your submission about the

“balance of public opinion in Scotland”,

do you feel that the political parties have got it right on greater autonomy? Are some too

cautious? How do you feel about some of the submissions to the Smith commission, in that respect?

Professor Muscatelli: I stress the point that I made on page 1 of my submission:

“The democratic criterion is key to any settlement.”

Let me put it this way—if it were to turn out that public opinion was that there had been insufficient devolution of powers to Scotland, I would not be surprised if public opinion then translated itself into the public saying that they want more powers. It is important for the political parties and the Smith commission to get it right in terms of capturing the mood of the country. There would soon be demands for more powers if too few were to be granted through whatever settlement emerges from the Smith commission's work.

What is interesting for me, having done work for the Commission on Scottish Devolution, is that public opinion seems to have shifted towards demanding more powers. To some extent, that is not surprising because since the creation of the Scottish Parliament trust in its work has built up and grown. I think that people were initially cautious about it, but they are now in a very different place. This is simply my view of public opinion; I am not a psephologist. However, from just observing the mood of the country and what people say, they do seem to want more tax-raising powers and they perceive the vertical imbalance as being a real issue.

The Convener: Thank you for your answers so far. The first colleague to ask a question is Jamie Hepburn, followed by Michael McMahon.

Jamie Hepburn (Cumbernauld and Kilsyth) (SNP): I will stick with the same area. Professor Muscatelli, you spoke of the need for the Smith commission to reflect what the public think. Is it incumbent on the Smith commission to involve the public in its process? The Parliament has resolved that the people should be involved in the process. Do you think that that is important? If so, how can the Smith commission accommodate it?

Professor Muscatelli: It is difficult to say, given the demanding timetable that the commission has. It is interesting—

Jamie Hepburn: I am sorry to interrupt you, but I should make it clear that I am talking not about the Smith commission itself but about the entire process, including what happens after the commission has reported.

Professor Muscatelli: It is right that that is probably when the opportunity for such involvement will arise, given the timetable that the Smith commission has and given that there will be a pause before any legislation is considered by the UK Parliament and the Scottish Parliament. It is

critical that people's voices are heard because, as I said, if we do not get it right collectively, the political parties will soon revisit the debate about whether more powers should have been devolved. I have been quite surprised by how much public opinion seems to have shifted even in the past five or six years on the range of taxes that should be devolved. I think that people should be heard.

Jamie Hepburn: In your submission, you state:

"If there are major differences in political preferences and social attitudes on public good provision and taxation and benefit structures, then a highly devolved system is more desirable."

Does that apply to Scotland and the rest of the UK?

Professor Muscatelli: I think so. The public policy that is emerging from the Scottish Parliament in areas such as health, education and higher education is very different from that which is emerging from the UK Parliament. Given those differences, more devolved taxation would be desirable, because Scotland needs the instruments to finance those policy decisions.

Jamie Hepburn: You spoke about the possible further devolution of income tax and other taxes, and you suggested that HMRC should continue to collect the taxes in that context, because that would be more cost effective. However, even for the limited taxation powers that were devolved under the Scotland Act 2012, the Scottish Government explored that option and found that it was more cost effective to establish Revenue Scotland, because using HMRC would cost more. Given that, could Revenue Scotland's powers require to be enhanced in the context of additional devolution?

Professor Muscatelli: That is definitely a possibility. There needs to be a grown-up discussion between the UK Government and the Scottish Government on the matter.

Revenue Scotland was established to avoid the additional cost that you described. In a sense, that was because the Scottish rate of income tax and the other taxes were seen as add-ons, but they should not be seen as add-ons. If we have a devolved system of taxation in the UK that allows Scotland and, in the future, possibly Wales and other parts of the UK to have different rates of taxes—we might even see devolution at the city region level in England, resulting in local income taxes—we should really think about the efficiency of having one agency serving all the parts of the UK. If that turns out to be more expensive, the different parts of the UK will set up their own agencies.

There needs to be a grown-up discussion between the Scottish Government and the UK Government about equal rights of access to

agencies for which they should be able to pool the costs. As you say, if that does not work, the alternative is to enhance Revenue Scotland's powers and scope.

Jamie Hepburn: One of the drivers for Revenue Scotland was cost effectiveness, but another advantage is that Revenue Scotland is wholly accountable to the Scottish Parliament, whereas it might be difficult to make HMRC accountable to multiple jurisdictions. Is there an advantage in that more straightforward approach, whereby Revenue Scotland is wholly accountable to this Parliament?

Professor Muscatelli: That could be advantageous. On the other hand, I do not see why agencies cannot be responsible and accountable in different ways. I will give you an example from my sector. We have the Quality Assurance Agency for Higher Education, which serves England and Scotland in very different ways because we have different quality assurance systems, yet both places can share its back-office functions. There might be advantages in having separate agencies, but an alternative might be to say to HMRC, "Sorry, but you are accountable to the Scottish Parliament just as much as to the UK Parliament, and if you don't fulfil your duties the Scottish Parliament can call you to account."

Jamie Hepburn: That would require some form of legislative tweak—I do not know the legislation that would cover it—so that not only would HMRC be accountable to us, but we could legislate for its functions.

Professor Muscatelli: Indeed. That leads us on to an interesting point. Once we start having much greater devolution, which takes us into an almost federal structure, it is important that different levels of Government—Government at the UK and Scottish levels—can negotiate and take intergovernmental decisions. We must not ignore that element.

There needs to be parity of esteem. We cannot just say that, because the Scottish Parliament can legislate only on certain matters, it cannot influence matters that are of interest to it, such as the use of common agencies. There need to be mechanisms to do that; otherwise, we are moving towards a federal type of structure for taxation but not government.

Jamie Hepburn: Your submission states that

"Oil and gas taxation is geographically well-defined, and could be devolved."

Others who have given evidence have also made that point. You go on to say that, if that was the case, some form of "oil stabilization fund" should be established. Of course, the Scottish Government has also called for that. You add that

"If these taxes are devolved they should be fully devolved."

What makes you come to that position?

Professor Muscatelli: One issue that came up during the independence debate was that the oil and gas sector needs some stability and certainty over what policy governs the North Sea, because we are at a critical point when long-term investment decisions have to be fully considered. If oil and gas taxation is to be devolved—that is technically possible and we can see why it might be done—there should not be a division of powers, because that would lead to confusion in the sector. If it is technically possible to devolve that taxation—it accounts for a sizeable amount, which might help to reduce the vertical imbalance—it should be fully devolved and it should be the Scottish Government's responsibility to govern all aspects of oil and gas taxation.

Jamie Hepburn: I presume that that would include the licensing regime.

Professor Muscatelli: Yes.

Jamie Hepburn: Your submission refers to VAT. Everyone who has referred to VAT has made the point that European Union rules are such that legislative competence for it could not be devolved, but you suggest that assignation could be a possibility. You do not state whether you support that proposal, so you can comment on that. I take on board the point that, if VAT were assigned, the Scottish Government could not be formally involved in setting the rates, but should it have to be consulted on the rates?

Professor Muscatelli: As I say in my submission, the advantage of assignation is that, as VAT accounted for about £9.3 billion in 2012-13, it would reduce the vertical imbalance and provide greater accountability. If we had assignation of taxes to the devolved authorities in the UK, it would be natural to have some sort of consultation process.

In reality, VAT rates do not move too much, except when there is an imperative to raise more taxes. However, consultation would certainly be quite important. If VAT were assigned, although the public would view it as a tax for which responsibility lies with the UK Parliament, when it came to the scope of VAT, the Scottish Parliament might feel that it would like to ensure that VAT applied on certain goods and services, because the tax has an impact on income distribution issues. I would have thought that some form of consultation on the overall policy would be best.

Jamie Hepburn: I presume that the idea of assignation is that this Parliament and the Scottish Government might have other tools at their disposal that could influence the revenue stream.

Is the Scottish Parliament properly equipped to influence how much VAT revenue is collected?

Professor Muscatelli: If there is assignation, there is certainly less accountability, because tax rates cannot be influenced, so the tax take cannot be directly influenced. On the other hand, it would certainly raise awareness of VAT and its tax base in Scotland. It might lead to some interesting debates about how economic development impacts on that tax. I would have thought that it would increase accountability at the margins.

In other countries that use VAT assignation, there are debates at the political level in the devolved authorities about that tax take, which is probably healthy. It would interact with some of the other tax rates in relation to economic development, of course.

10:30

Jamie Hepburn: The devolution of air passenger duty was suggested by the Calman commission, which I believe that you were involved in advising. The Conservatives and the Liberal Democrats have recommended its devolution, and your submission says that it would be suitable to be devolved. Why has it not been devolved thus far?

Professor Muscatelli: I was not privy to some of the debates. I was surprised that APD was not in the Scotland Act 2012, because we were clear that it would not lead to huge amounts of tax competition. If anything, it might help with some of the air transport issues around the UK by creating alternative hubs to some of the overstretched hubs in south-east England.

I do not know the answer to your question. I am not sure why the decision was made. I suspect that it might have been because of fears about tax competition, but that would not be a problem. Devolving APD might be helpful rather than harmful.

Michael McMahon (Uddingston and Bellshill) (Lab): You have touched on welfare and benefits, and I am looking for a bit of clarity about your thinking. You suggest that some benefits are more readily able to be devolved, and the one that comes to mind is housing benefit. There are obvious reasons for that. However, others who have looked at the issue have said that, although that might well be the case, it would be difficult to unpick universal credit in general. Can I have your thoughts on the practical difficulties of that unpicking?

Professor Muscatelli: If we start with a particular fixed structure to benefits and devolve it as it is, that becomes much more complex administratively. There is merit in looking at

devolving benefits such as housing benefit and tax credits. One of my concerns is that, if we really want to address income inequality, we have to look at low salaries and have control over personal allowances.

We have to look at the potential to use tax credits to help the transition into work. If that is thought of as more of a benefit than a tax credit and if it belongs in the benefits structure and is therefore reserved, there will be difficult issues with conflicting decisions that could impact negatively on low-paid workers. That makes me think that, although universal credit would be difficult to unpick, if that was not done and if benefits such as housing benefit, tax credits or other benefits were not assigned to help people into work, the danger is that there could start to be conflicting decisions in different parts of the UK about very low wage levels.

There is merit in looking at the devolution of those benefits for that reason. It might not work readily under the current benefits structure, but perhaps we need to look at that as well, to see how it can be made more linear and divided more neatly between the jurisdictions.

Michael McMahon: If we are talking about using tax credits in relation to employability, that has to be tied to the overall income structures.

Professor Muscatelli: Absolutely.

Michael McMahon: How difficult does that become?

Professor Muscatelli: Once we start to devolve tax allowances, thresholds and rates, it is not much more difficult to devolve tax credits. One reason why the UK finds it so difficult to play in that space and have a much more efficient system is that we pride ourselves on the fact that few people in the UK submit tax returns. Because most of the tax revenue take is through PAYE, we end up having to assign tax credits and then claim them back if we find that people have earned more than the requirement.

We might have to look at the efficiency of that. It would be much easier to have comprehensive devolution and then add tax credits into the mix if we took a slightly different approach to analysing tax returns and perhaps had systems that allowed individuals through PAYE also to deal with issues such as tax credits. Most other countries do that; in most countries, everybody has to file a tax return. That is simple and it deals in an integrated way with in-work benefits, tax credits and taxes. We might have to start looking at that as a possibility.

Michael McMahon: In other countries in the United Kingdom, there is already quite extensive devolution of welfare. Northern Ireland ostensibly

already has the maximum amount of devolution of welfare. Until recently—probably more for political than financial reasons—it had never had different benefit rates or services from those provided in the rest of the United Kingdom but, when it took a different approach recently, that led to it requiring a loan, in effect, of £100 million, which has to be paid back to the UK Government. Could we end up with that type of difficulty if we do not get further devolution of welfare under the Smith commission?

Professor Muscatelli: The issue seems to be more about what we discussed earlier—what happens once extensive powers are devolved. Maintaining revenue and spend in line requires smoothing over time. If we made a decision on benefits or taxes, that might reduce the tax take, and we would need to borrow or to have access to a stabilisation fund to deal with that.

If we are to have a grown-up discussion about devolving extensive powers to the Scottish Parliament, we have to accept that there will be issues with alignment. Revenue, taxation and spend will not always be perfectly aligned and there will need to be ways of handling that.

To return to your key point, I think that, if we devolve bits of the benefit structure but not others, we could end up with unintended consequences. We need to look carefully at the full structure of benefits. It is a bit like the position with income taxation. If we are to devolve some of it, we should devolve as much as we can, to avoid a large degree of overlap that would lead to issues of competition on benefits.

Michael McMahon: That is helpful—thank you.

John Mason (Glasgow Shettleston) (SNP): Good morning, professor. My questions build on some things that have already been said. You said that you have been surprised that the public appetite has moved quite a lot in a relatively short time. Is the reality that the public appetite, preference or whatever will always be changing so there is no right answer? Will we have to change the rules or the arrangements every five years to fit in with what people want?

Professor Muscatelli: I think that there has been a definitive switch towards a desire for greater fiscal powers. It is difficult to go back, to be frank. We are now in a situation where people seem to want more fiscal powers, and there are very different demands in the nature of the public goods that will be offered in Scotland relative to the rest of the UK, which I suspect should lead us to a situation where as many more fiscal powers as is practical without creating too much tax competition should be devolved.

I think that it would be difficult to turn back the clock. If in the future the Scottish electorate's

desire for public goods becomes more aligned with that in the rest of the UK, we will simply find that the tax rates become more aligned over time, as will the patterns of spending. The movement will tend to be in that one direction. We have generally seen federal states evolve over time, and powers devolve. Movement tends to be towards more devolution; greater centralisation does not always follow. Governments and Parliaments simply learn to use their powers in ways that match the desires of their electorate.

John Mason: Should we try to anticipate the desires of the electorate in the future, or should we just do a certain amount now and revisit it?

Professor Muscatelli: We should end up with a rational structure that avoids too much overlap and too much competition. I will give one example. One of the issues that we faced with the proposals that were put into the Scotland Act 2012 was that they led to disputes over the calculation of the block grant. That is the sort of thing that we want to avoid on this occasion. We need to avoid a situation in which, if we devolve taxes for X, Y and Z, we start having rather difficult and sterile debates around areas of overlap.

That is why I suggest in my submission that we need to begin to think more laterally. Suppose, as I do towards the end of my paper, that the Smith commission and the resulting legislation end up giving quite a lot more powers to the Scottish Parliament; we may then need to anticipate ways of addressing the impact of that in future, for example by having an equalisation fund. There may be an appetite for that in the future because people care about there being different levels of provision of public goods around the UK. The mechanism clearly cannot be the block grant that is currently imagined. Suppose that Scotland ends up with almost full fiscal autonomy and the Scottish Government controls 80 to 100 per cent of its spend through taxation; would we then want an equalisation fund of sorts in the UK?

John Mason: Do you mean an equalisation fund between poorer and richer parts of the UK?

Professor Muscatelli: Do we want such a fund? Maybe no, maybe yes. I think that the debate has to be had. That is the sort of discussion that is needed.

The lesson from what has happened before is that we should try to avoid unintended consequences. We should try to make decisions on devolving taxes that avoid halfway houses that lead to disputes. We should look carefully at the interaction between the tax base and issues such as the block grant, and avoid potential conflict between jurisdictions in the future.

John Mason: You raise a lot of points; we could spend a lot of time on some of them.

I am interested in the equalisation idea. You mention in your submission, towards the end of page 2, that other countries address equity in different ways. You say that Australia and Germany put an emphasis on it, whereas Canada, the USA and Switzerland are more relaxed about differences between their provinces, states and cantons. Are you saying that that is the debate that we need to have rather than that one way is right and one is wrong?

Professor Muscatelli: Absolutely. That is the debate that we need to have. It is an interesting debate. We could begin, without even specifying what the mechanism will be, by enshrining as a principle that the two Governments or the two Parliaments will have that discussion going forward if there are major differentials.

Let us not forget that it is not just about Scotland and the UK—there are pushes in Wales for greater devolution, and indeed in Northern Ireland, as has been mentioned. In the future, we could easily get into a situation in which we may need mechanisms that will address those issues. It is a debate that we have to have, and there is no right answer.

If there are very different desires with regard to levels of spending on public goods and the range of public goods, that is an argument for much more devolved taxation. Equalisation mechanisms become an issue if the electorate thinks that equity is a major issue. At the moment it seems to be less central to the current debate.

John Mason: That also raises the issue that there is a lot of variation within England. You mentioned the different performance of the London economy. You also link the demand for devolution with uneven regional economic performance, which applies in England, and yet there does not seem to be the demand for devolution in England.

10:45

Professor Muscatelli: It is complicated, is it not? When the north-east regional assembly was proposed, there was not a vote in favour. I do not know a huge amount about English devolution, but whenever I have discussions with people who know quite a bit about it, they say that a problem is how the issue is framed, so although people in England have a desire for greater powers, that tends to be much more associated with city regions than regional areas with which they feel little association.

Looking at the data on the UK's development over the past 20 to 30 years, people worry a lot about inequality and uneven economic development. Those are largely driven by the performance of London and the south-east relative

to that of the rest of the UK. Indeed. I recently saw a striking bit of evidence in a paper by David Bell and a co-author that showed that the drive towards inequality in the UK could be largely explained by what is happening in London and the south-east. In that situation you would expect that, over time, the demand for greater devolution would grow, even in England. It might be framed around city regions rather than regional governments.

John Mason: You used the word “overlap” a few times and I think that you mentioned “halfway houses”. From what you have said to other committee members, you quite like the idea that it is tidier and makes more sense if the whole of a particular tax goes one way or the other.

You say in your submission:

“devolving income tax completely would introduce more complexity but this is already managed within other countries, which have multi-level income taxation.”

Is income taxation a little bit different in that it can be done at both levels or do you still argue that that is best done at one level?

Professor Muscatelli: It comes back to my earlier point: if we are serious about moving towards having most of the spend covered by taxation raised in Scotland, that cannot be done without devolving pretty much all income taxation and, indeed, going beyond that, because you would need to look at other taxes or you would not get to the numbers that people would want, which are in excess of what we see even through the Scotland Act 2012, which would raise the tax percentage only to 17 per cent.

My other point is that, if you split taxation and you have a shared tax base, you then start getting potential disputes over that. It is cleaner in many respects if you avoid that by saying that income tax be fully devolved to the Scottish Parliament and that it has full freedom of action over all elements of that. That would take care of a large proportion of the Scottish Parliament’s total spend. It is not surprising that many of the tax proposals have come from the political parties. Indeed, the Institute for Public Policy Research and Reform Scotland say that income tax is the first tax that you would devolve and you would have to devolve it in its entirety.

John Mason: National insurance is an interesting one; indeed, we have had a range of opinion on that. You seem to take the line that it is effectively income tax and should be treated as such; others have been strong on the line that it is linked to benefits and welfare, and should be seen as distinct from income tax. What is your response to that line?

Professor Muscatelli: I have changed my mind over time about that. Initially—to go back seven or

eight years ago—I shared the view that national insurance was different from income tax. However, when you look at the link between national insurance contributions and the amounts that are spent on benefits, you see that that link is pretty much non-existent.

The other element that makes me consider that national insurance—or at least employee national insurance—is just a tax on employment income is that it leads to a bizarre pattern of marginal tax rates in the UK as you move from low to high pay. Therefore, we have much higher marginal tax rates somewhere in the middle of the distribution, which is slightly odd to be honest.

Occasionally, you see Chancellors of the Exchequer saying that they could perhaps put an extra penny on national insurance across the whole range in order to take care of another bit of spend. The situation is very untidy. If you want to make taxation more transparent, you should probably look over time to integrate the two—there is very little link in the amount that is raised through national insurance contributions by employees and the benefits that are offered.

John Mason: That is what I think, too, so I like that answer. Say you have 20p income tax and 10p national insurance and then you abolish national insurance and have 30p income tax. Would the public react a wee bit against that?

Professor Muscatelli: The public might initially ask more questions but, at the end of the day, what they care about is their pay packet. If it resulted in the same amount of take-home pay, I do not think that they would care. They would quickly understand it. The public would be quite rational once they started seeing how it impacts on them.

John Mason: You also mentioned VAT, which has been touched on already. You talk about

“EU rules which may make VAT variation within the UK difficult”.

Others have said that VAT variation within the UK is impossible, but you say that it is “difficult”. Do you think that it could be done?

Professor Muscatelli: I do not think that it could be done. It would be difficult—impossible. I cannot see the EU agreeing to that sort of dual arrangement within the same state. There is a way round it, which is assignation. To be honest, that is the neatest solution.

John Mason: Other witnesses have argued very much against assignation because they felt that we would be taking on the risk without any of the control.

Professor Muscatelli: It comes back to the discussion. If Scotland gets assignation, it needs

to be possible for Scotland to have a dialogue with the UK Government about the scope of VAT. VAT rates do not tend to change very much. We have seen them rise occasionally at times of fiscal crisis, when we suddenly need to find a quick way of raising income.

The thing that concerns me more is whether the scope of VAT might change over time. For instance, could items that are zero rated at the moment come within the scope of VAT in future? If we have assignation, in some sense the general public thinks, "This is a tax that accrues to the Scottish Parliament." There needs to be a dialogue on issues such as that because they are politically quite sensitive.

The other issue might be whether, in future, we think about making VAT more progressive. A number of countries have higher bands for luxury items for instance. Again, some people see that as a good way of dealing with issues such as inequality. That is the sort of thing on which, if there is assignation, there should be a dialogue, in which the Scottish Parliament is able to say, "We think that this would be quite a good way to devolve VAT," and for there to be a debate, although ultimately the responsibility would rest with the UK Parliament.

John Mason: Is it your understanding that both the rate and the scope of VAT would have to be centralised and there could not be any variation in either of those?

Professor Muscatelli: Yes.

Jean Urquhart (Highlands and Islands) (Ind): John Mason has asked a couple of the questions that I had been going to ask. I was pleased to hear Professor Muscatelli's response on national insurance contributions.

All the submissions talk about income tax as being the basis for this discussion on the future of devolved taxes, but it is one of the most volatile taxes. Is there any security? You suggested earlier that if there were any imbalance, it would be for the Scottish Government to use borrowing powers. However, given that we are not, I suspect, going to have full fiscal autonomy, and that there will still be some form of devolved budget from Westminster to Scotland—whether or not it is called the Barnett formula—would it be unacceptable to think that that system would be used to provide security for Scotland's income from tax?

Professor Muscatelli: Unless you have full fiscal autonomy, on current figures you would need some element of block grant. Otherwise, Scotland would be put in a very difficult and unfair position. If you do not devolve all taxes, by definition some taxes are reserved and therefore Scotland would have to have access to its share through a block grant.

I suppose that there is then the question of how you would determine that block grant. At the moment, because it is still such a large element and has always been there, we have stuck with the Barnett formula. Suppose that you devolved income taxation and oil and gas taxation but retained other taxes so that Scotland had control over a reasonable proportion, although nothing like full fiscal autonomy; you would need to look at how you used that block grant to ensure that you did not get too much instability in the resources available to the Parliament.

It comes back my earlier point about whether the block grant should then act as an equalisation grant. Also, should it be more needs based? The Barnett formula is historical. Scotland has particular needs to do with its geography and its rural communities. It is not just Scotland. If Wales starts moving in this direction, should we not look at something that is more needs based and more rational, given the taxes that have been devolved?

Jean Urquhart: What would you consider to be the most important economic levers of power?

Professor Muscatelli: In terms of economic development and the possibility of impacting on that?

Jean Urquhart: Yes, in terms of economic growth.

Professor Muscatelli: Certainly, income taxation and corporation taxes are important, as are employers' national insurance contributions—a way of encouraging employment would be to say, "We would like to encourage inward investment by using that particular lever." In the context of Scotland, there is oil and gas taxation as well. Although it is less than it was and there are uncertainties around future development, it is that very uncertainty that requires us to have some very clear levers and some encouragement for a sector that could still be hugely important for Scotland in terms of revenue.

Jean Urquhart: As far as the Smith commission work is concerned, would some form of security for the Scottish Parliament be important, such as a written constitution for Scotland under which the Westminster Parliament could not abolish the Scottish Parliament or which somehow could be used to agree political differences?

Professor Muscatelli: I am not a constitutional lawyer. I was born in Italy, which has had a written constitution for a long time, and I like written constitutions. However, if there is a strong democratic will that it is important for the Scottish Parliament to be safeguarded, I cannot see why that safeguard could not come out of the Smith commission process. Indeed, in terms of ensuring that we cannot go backwards when it comes to devolving responsibilities, I cannot see why that

should not be enshrined in what is currently the unwritten UK constitution.

Jean Urquhart: Finally, would you say that the ability of the Scottish Government to raise new, as yet unthought of taxes—for example, taxes to do with land—should not affect any other adjustment, in the form of the block grant or anything else? Should there be opportunities for Scotland to create new taxes that it could grow, perhaps taking a different direction from the rest of the UK, but which would nevertheless be independent from the block grant?

Professor Muscatelli: I think that you are absolutely right. If we take the position that the current block grant is in some sense a payment that is a proxy for Scotland's share of revenues and resources at UK level, the block grant should not be reduced because Scotland decides to start taxing in a particular area that is not currently taxed anywhere else in the UK. I think that reducing the block grant in that situation would be grossly unfair, to be honest. If Scotland decides to raise new taxes, it should have a dialogue with the rest of the UK about it. Changes in taxation practice and taxation innovation happen all the time and it might be a great idea—for example, it might be an environmental tax that could be of use to the rest of the UK—so there should be a dialogue. However, I absolutely agree with your point that there should not be an adjustment to the block grant.

Jean Urquhart: Finally, convener, if I may—

The Convener: Finally, finally.

Jean Urquhart: On that basis, do you think that those conversations might be difficult, given that there could be political differences? For example, some people think that reducing taxes is a way to get economic growth; others may see raising taxes as a way to get economic growth.

Professor Muscatelli: Yes, those conversations would be difficult. However, we need to have them if we are serious about creating a more devolved structure in the UK—I know that the word “federal” has been used, although that is a slight misnomer. As I say in my paper, there are a lot of federal countries where there is possibly less devolution of powers.

11:00

If substantial powers are devolved to the Scottish Parliament, there must be parity of esteem and an ability for the Governments to agree that the Scottish Government is in control of taxation for 50, 60, 80 or 100 per cent of its revenues. It is important to have such dialogues, even if the decisions of the two Parliaments might differ, to ensure that decisions are not taken that

have spillover effects on the other country. It is about the two Parliaments recognising their interdependence and desiring to at least collaborate even though, as you said, the thrust of the policies might be very different north and south of the border.

Jean Urquhart: Thank you.

Malcolm Chisholm (Edinburgh Northern and Leith) (Lab): Professor Muscatelli, you used the words “fiscal autonomy” in one of your answers to Jean Urquhart. Fiscal autonomy could have two meanings: either devo max fiscal autonomy, or having enough taxation to cover whatever areas of policy are covered by a devolved Parliament. You also talked about avoiding disputes over the block grant. Do you think that it is possible or desirable for this Parliament to have sufficient taxation powers to cover all the expenditure areas for which it is responsible?

Professor Muscatelli: My view is that that is where public opinion has gone; people want to see that level of accountability so that you have pretty much full coverage of the total spend of the Scottish Parliament. Again, I think that the position on that has shifted radically over the past few years. If there is not to be that level of accountability and instead a larger amount was to come through the block grant, you would end up again with the Scottish Parliament not being fully accountable.

Malcolm Chisholm: In your last series of answers you used the phrase “block grant” on more than one occasion. Do you see the block grant operating as it currently does by topping up? Your last answer suggests that you are using the term “block grant” more to mean an equalisation fund.

Professor Muscatelli: That would depend on the amount of taxation raised here. If the Smith commission and subsequent legislation were to suggest that 40 or 50 per cent of the Scottish Parliament's total spend was to be covered by its own taxation, I suspect that the block grant would not be just an equalisation fund because it would have to make up the real resource that would be needed because of the taxation that remained reserved. If the Scottish Parliament's taxation were to go towards 80, 90 or 100 per cent and the block grant still existed, it would simply be an equalisation fund and would be a matter of negotiation between the two Governments on dealing with ebbs and flows and trends in gross domestic product per capita across these islands. As I said, it would depend on the amount.

Malcolm Chisholm: It sounds as though you favour the latter approach.

Professor Muscatelli: I think that I do, simply because of my observation that public opinion is

such that accountability has become the key issue, whereas people were previously more concerned about horizontal equity. People, certainly in Scotland, believe that the Scottish Parliament should be responsible for raising the resources for the areas on which it spends.

Malcolm Chisholm: Various arguments against that are often used, and your submission talks about “asymmetric macroeconomic shocks”. We could imagine an economic shock that affected Scotland more than the rest of the UK, so that would be one kind of risk.

The other kind of risk would obviously be one of the devolved taxes’ revenues declining—oil taxation is the one that is most often cited in that regard. In fact, the view of our witness last week, Jim Gallagher, was that we should devolve oil taxation if we want to cut public expenditure in Scotland. What is your view of that kind of critique of having equality between expenditure and taxation with no provision for macroeconomic shocks or for declining resources from a devolved tax?

Professor Muscatelli: With accountability comes responsibility. The Scottish Parliament would need to recognise that some taxes are more stable and some are more volatile, and it would need to have mechanisms to smooth spending over time and to borrow. If one tax base was genuinely in decline over time, it would be the Scottish Parliament’s responsibility to say that we need to grow the economy and other sectors in such a way that the tax base would grow and allow us to meet needs for public goods.

There are ways of handling short-term macroeconomic shocks; I have mentioned an oil stabilisation fund and borrowing. If it was thought that there would be long-term declining trends in some tax bases—oil and gas are the only obvious one—the Scottish Parliament would need to factor that in and ensure that it could, through the levers that it was given, grow the economy to try to offset that over time. However, such a decline would not happen instantaneously; it could happen over decades. That is less a macroeconomic shock than it is an economic development trend.

Malcolm Chisholm: Obviously, the more areas that are devolved—welfare or whatever—the more tax will have to come in to cover all that.

To go back to corporation tax, I did not totally understand your explanation of differential rates that are linked to employment levels, to be honest. I do not know whether you want to try that explanation again. I suppose that the other possibility for corporation tax would be assignment. Is there an argument for that?

Professor Muscatelli: It is clear that corporation tax could be assigned, as VAT would

be assigned, but the big problem is that Scotland would not be given the economic levers that it wants in order to achieve that. A lot of that was described quite well in the Holtham commission report on Wales.

Corporation tax could be a very useful lever, particularly if one is trying to deal with circular changes in sectors, to come back to your earlier point. There might be a real interest in reindustrialising Scotland to ensure that it becomes increasingly competitive over time, but it is difficult to do that without the full range of economic levers. Corporation tax and employers’ national insurance might be among the sorts of things that would be needed to create that impetus.

Malcolm Chisholm: Obviously, we do not want to rerun the referendum debate about corporation tax, but I have two practical questions. First, why would the rest of the United Kingdom find it acceptable for Scotland to have a lower rate of corporation tax? Secondly, how effective would that be anyway? We have heard different evidence on that over the past few months.

Professor Muscatelli: You are right: if we did not take into account how the tax is calculated, there could simply be brass-plate operations—we have seen that in jurisdictions such as Switzerland, where cantons have the ability to take that approach—and there are then simply profit transfers across different jurisdictions. When corporation tax is linked to real economic development variables—I give the example of the Holtham commission’s argument around employment—it is more difficult to manipulate.

The other way to do it is through co-ordination. It could be said that the Governments should talk about these things. One approach would be to allow corporation tax to be varied by up to plus or minus X per cent. I suspect that the UK Government would be grown up about Scotland deciding to have 2p or 3p less than the UK rate of corporation tax and would, to be frank, think that the impact on the rest of the UK would not be huge, and it might prefer to have a different balance. That could lead to a more grown-up discussion around corporation tax and to different balances of taxation within the UK.

We are simply used to a system in which people do not vary income taxes or, indeed, any other taxes very much across the UK. If more powers are to be devolved, there can be more grown-up debates about that and it might be found—I hope—that different choices would be made. I suspect that they would be.

Malcolm Chisholm: Finally, you say in your paper that assignment of VAT is a possibility; I have in the course of questioning got the

impression that you support a degree of assignment of VAT.

Professor Muscatelli: Yes.

Malcolm Chisholm: You have also said that VAT does not change much over time. I think that there has been an upward movement of VAT in general, which has probably compensated to some extent for income tax remaining the same or going in the opposite direction.

Most people who support assignment of VAT do not seem to have strong arguments for it. I might be totally wrong about this, but would it be a problem if the UK Government were to make further reductions in VAT and increases in income taxes? Is that catered for under the block grant adjustment for the income tax that we will get, or would there have to be further provision to deal with it? Otherwise, Scottish people might have to pay the high rates of VAT that the rest of the UK has and would also have to pay a higher rate of income tax in order to maintain public expenditure in Scotland.

Professor Muscatelli: That is a fair point. If the block grant were to remain an element of the total package and VAT were assigned, we would certainly not want more adjustments to the block grant, which would be a double whammy for Scotland. It would need to be written into the arrangement that, if the UK Government were to move VAT to 22.5 per cent, for example, Scotland should benefit from that but should not then lose that benefit in the block grant. That is the sort of complication that I mentioned. If we start having halfway houses with block grants being offset, we will need to include such conditions because the arrangement could otherwise lead in the future to real disputes between the Governments. You have just highlighted one area where that could happen.

Gavin Brown (Lothian) (Con): In your submission, you used the expression "Appropriately extended borrowing powers". How much the powers ought to be extended will obviously have some link to which taxes are devolved. At a more fundamental level, are you arguing for greater scope for borrowing regardless of which taxes are devolved, or are you saying that the extension should be linked closely to which taxes are devolved?

Professor Muscatelli: Scope for borrowing should be linked to the level of fiscal autonomy. Under full fiscal autonomy, far greater borrowing powers would be needed. That should be done in the context of whatever the fiscal rules are for the UK because, if macroeconomic policy is going to be reserved, some sort of fiscal pact will need to apply to the UK Government, but must translate into whatever is appropriate for Scotland. If, in the future, the UK Government were to design a deficit

rule that was plus or minus 2 per cent, or set a structural balance, that would need to be translated in some way through agreement with the Scottish Parliament.

The level of borrowing powers would need to some extent to be designed based on analysis of devolved taxes. In the scenario in which oil taxation and income taxes were devolved, we would need to analyse how they moved over time and consider what scope there would need to be for borrowing to offset sudden changes over the economic cycle.

Gavin Brown: When I read your submission, I got the impression that you were keener on devolving employee national insurance than on devolving employer national insurance, but your oral evidence is slightly different. Is it possible to devolve one without the other, or are you in favour of devolving both?

Professor Muscatelli: We could separate the two. Employee national insurance is much more linked to personal taxation, although it is based on employment income. There are merits in considering both for devolution. There would be merits in devolving employee national insurance because it is integral to the structure of personal taxation, and in devolving employer national insurance because it might be an effective tool to deal with employment and economic development.

Gavin Brown: In your submission, you touch briefly on duties including fuel, alcohol and tobacco duties, which have not yet come up. What is your view on whether and to what extent they ought to be devolved?

Professor Muscatelli: Devolution of those duties across a territory such as the UK could lead to tax avoidance simply by people moving around or shopping around, and to illegal trafficking. It is an interesting policy area because it overlaps with an area of public policy: different parts of the UK might have different views about consumption of tobacco or alcohol. There needs to be a debate about the issue. We should try to avoid there being many complications, although in the US there are different sales taxes and people shop across state lines. It is not impossible to devolve duties.

I think there needs to be a discussion. Those duties are less important as a revenue source, although revenue from them is still substantial. It largely depends on whether the Scottish Parliament wants to have a substantially different policy towards the bads—if you like—of tobacco and alcohol consumption. If it does, there might be merit in looking at that and having a discussion with the UK Parliament about limits. However, you want to avoid huge variations, because they would

cause large-scale tax avoidance, trafficking and so on.

11:15

Gavin Brown: Your answer to my next question has probably been implicit in what you have already said. Some of those who are in favour of VAT assignment have said that the entire portion should be assigned and others have said that a percentage should be assigned. Do you have a view on whether it should be the entire portion or a fraction of it?

Professor Muscatelli: I do not have a strong view on that; it would depend on the total package. If, for example, the feeling is that you should aim for 80 per cent coverage of spend, that could be seen as a residual element. The only reason why you might not want to assign all of VAT is if you want to use it as an equalisation fund. Germany and other jurisdictions tend to have partial assignment as a way of saying, "Let's retain part of this and use it as the equalisation fund." That is the argument for partial assignment.

Gavin Brown: You have been asked a couple of questions on corporation tax. I want to go a bit deeper into one of the answers that you gave to Malcolm Chisholm. You said that, ultimately, we could have what you described as a Holtham solution, part of which might be intergovernmental co-operation to agree a broad framework. You said that corporation tax could be varied by plus or minus X per cent. That is an interesting idea, but if X is a huge number, various jurisdictions might rail against it, and if it is a small number, we could argue that it might not make any difference. In theory, we could say exactly what you said, but in practice, do you foresee a situation where that X per cent could be big enough to make an impact but small enough that it would not cause disharmony amongst jurisdictions?

Professor Muscatelli: I think that it could have an impact, even if X per cent was not huge, or there was full devolution but the Scottish Parliament decided to exercise its powers only at the margins in order to avoid having too big a disparity. If we worked through a Holtham solution, we could think about employment costs being 2 to 3 per cent less in part of the UK. That might have an impact on choices. For instance, if a company in the south-east of England was thinking of locating instead in Scotland, corporation tax might be a sufficiently powerful economic lever—depending, of course, on how it is calculated and attributed. I do not think that it would be totally ineffective, but for the reasons that we have discussed, there needs to be a co-ordination mechanism to deal with it.

Gavin Brown: I am grateful. Thank you.

The Convener: That concludes questions from the committee. Are there any further points that you wish to make, Professor Muscatelli?

Professor Muscatelli: No. I think that we have covered most of the paper. Thank you again for inviting me.

The Convener: Most of the paper? *[Laughter.]* I think that I covered most of it, let alone the rest of the committee.

Thank you for your evidence today, which is very much appreciated. I will allow a break until 11.25 to allow a changeover of witnesses.

11:19

Meeting suspended.

11:29

On resuming—

The Convener: We will continue our consideration of further fiscal devolution by taking evidence from Professor Alan Trench and, from the campaign for Scottish home rule, Ben Thomson. Members have copies of the written evidence that our witnesses provided—two excellent submissions—so we will go straight to questions.

My first question is for Ben Thomson. In your submission, you include a copy of your letter to Lord Smith. The first sentence says:

"The Campaign for Scottish Home Rule ... includes people from across the political spectrum and from outwith politics who have come together to make the case for an effective, sustainable and productive Home Rule settlement for Scotland."

What do you mean by "sustainable"? Do you mean, for example, permanent?

Ben Thomson (Campaign for Scottish Home Rule): I am not sure whether anything is permanent if you go on long enough.

"Sustainable" means that you have clearly set out what the destination is—what Scottish home rule is. One of the problems is that the debate seems to be about welfare or certain taxes and has not been set in the context of what Scottish home rule means and where we are going.

The campaign's purpose is to say that we need a set of principles on which people can come together to agree the definition of Scottish home rule. We have put forward three principles, which are set out in our document, of what we believe is behind Scottish home rule, which is really about giving Scotland control over domestic matters and matching spending responsibilities with all the tools and levers that Scotland needs to deliver its domestic matters.

The Convener: I should have said at the outset, Professor Trench, that you should feel free to come in on a question that I ask to Ben Thomson. Likewise, Ben, when I ask a question specifically to Professor Trench, feel free to comment if you like.

You highlight three principles: “Responsibilities devolved”, “Raising what you spend” and “Mutual respect”. In the first line under “Responsibilities devolved”, you say:

“We believe there should be a presumption in favour of devolving responsibility to Holyrood.”

You include one or two wee caveats. For example, you say:

“we would argue that this would include substantial welfare powers.”

Can you give us a wee bit of clarification? Are you saying that powers should be devolved to Holyrood and then almost handed back to Westminster? That is how I interpret that statement. Why are you calling for “substantial welfare powers” rather than “welfare powers”? Can you define what you mean by that?

Ben Thomson: Funnily enough, I have just read a rather good article by Dave Watson of Unison that sets out rather well the principle of subsidiarity. Some UK powers are clearly to do with the UK, but if there is a grey area it is up to Westminster to justify why those powers should be reserved to Westminster. That is the first point of subsidiarity: Westminster should have to say, “These powers are for UK matters, therefore they belong to Westminster.”

As you know, about 70 areas of powers are currently reserved to Westminster. We feel that, for a number of those areas, the outcomes are delivered by Holyrood but the powers have remained at Westminster. An obvious example of that is in housing. The outcomes of housing provision are a local matter—they are a Scottish matter—but the welfare component of housing resides with the UK. That is an obvious aspect to push down. We have identified that about £6.5 billion of the current welfare budget of £14.4 billion, excluding pensions, would fall within the category of outcomes that should be passed down to Holyrood.

It is not just about welfare. In areas such as transport and employment law, some outcomes need to be delivered at the Scottish level but the powers are reserved to Westminster. We are saying that, because of the principle of subsidiarity, Westminster needs to justify why those powers are reserved. We suggest that, if the outcome from the use of those powers lies at Holyrood, the powers should be devolved.

The Convener: In effect, you are arguing that, because of the current situation,

“policy can end up being unfocussed and inefficient”.

You also say:

“Regardless of the merits of these programmes, the ability of Holyrood to address this problem”—

poverty and inequality—

“is seriously hampered because the main levers by which to address it are held by Westminster—the Scottish Government can do little more than tinker around the edges.”

Can you give us a couple of examples of that?

Ben Thomson: A classic example of that is labour. If we think of the outcome for Scotland as being getting people back into jobs, surely Scotland should have the full range of tools to enable people to get back into jobs. That covers how Scotland relates to the voluntary sector, and it involves some employment law and jobseekers allowance. That is just one instance of it. For an outcome that should be delivered by Scotland, let us get all the tools that Scotland needs to deliver it in one place.

You asked me for a couple of examples, so I will give you another one: housing. Although housing is principally a local government matter, some of the tools for it lie at the Westminster level, including housing benefit and fuel benefit. If you want to come up with holistic solutions, you need all the tools in one place. For instance, if a local authority wishes to implement a heating scheme in a different way, providing community heating, it should not be hamstrung by the fact that the fuel allowance is set at the Westminster level. It should be possible to do things in a much more holistic way using all the tools for delivering an outcome—which would be, for example, people having access to housing.

The Convener: Professor Trench, do you wish to comment on what has been said so far?

Professor Alan Trench: I am somewhat uneasy about that general approach. I do not think that time permits us to go into some rather distant discussion of general principles about putting all the tools in the hands of the Scottish Parliament to address particular problems. At this point, there is a need to be specific and detailed about what should and should not be devolved. Given the timescale that now applies following the referendum, airy discussions about levels of principle belong months and months ago, frankly.

The devo more work, which I discussed with you at a previous meeting in June, involved going through some of that detail, identifying things that could and should be devolved and things that could not and/or should not be devolved. At this

stage, you need something at that level of detail rather than something loftier.

In relation to what Mr Thomson just said regarding devolved powers, there is also a question about the need to think through the implications of the outcome of the referendum in a rather different way.

I would not have any objection whatever to fuel issues and heating being substantially devolved. We argued for the devolution of housing benefit in our paper “Devo more and welfare: Devolving benefits and policy for a stronger union”. It is obvious that that is a devolved function in the housing context and that all the levers should go with it. There are some strong policy reasons why the UK Government would want to devolve housing benefit—not merely to address a Scottish grievance, request or demand, as it were, but to improve policy outcomes.

The labour market is a very different matter because it involves a range of instruments that relate to the UK economy as a whole. I would regard the outcome of the referendum as saying that we are to preserve the UK economy, and putting up barriers to that economy by devolving things such as employment law and jobseekers allowance—which also relates to the idea of a social union—seems to run contrary to that principle.

Ben Thomson: Can I come back on that point?

The Convener: I will let you back in in a minute. I will put another point to Professor Trench and I will then let you come in on both of the issues, Ben. I am sure that things will heat up.

Professor Trench, the paper from the campaign for Scottish home rule says:

“We believe that the principle of raising what is spent is more important than the specific taxes which are initially devolved.”

Is that something that you agree with?

Professor Trench: No, it is not. You will struggle to find places where that principle applies. The one exception is the Basque Country, which is a more complex place than it is often considered to be.

Such an arrangement is simply not practicable within the constraints of the UK tax system. The paper “Funding devo more: Fiscal options for strengthening the union” ran through a number of the reasons why that is so. Considering the specific taxes that would be devolved, you simply cannot get to a figure that equates to 100 per cent of Scottish Parliament spend without causing some very serious fiscal distortions or spillovers.

Going back to the implications of the referendum, the result was an endorsement of

staying in the United Kingdom. The principle of the United Kingdom is that there is an expression of solidarity across the United Kingdom, which includes, inter alia, funding some services by grant to ensure that people have equal access—or at least to ensure the principle of equal access—to a similar range of public services no matter where they live. It is then a matter for the devolved Governments to decide what those services are and whether they are going to offer that package of services.

Ben Thomson: I am afraid that I totally disagree about the need to concentrate on specifics. Devo plus had specifics. Lots of people deal with specifics. It is completely a matter of putting the horse before the cart. Unless you can set out where we are going and what powers are going to be used, and unless you can win the public over on that, the specifics are just horse trading. Unless you can get across why we are doing something, the specifics are irrelevant.

The reason why we are trying to set out principles is that it is principles that allow the public to understand why we are making all these changes to taxation or welfare. There is a real belief that, if we do not have a set of principles underlying the changes, we will never put the matter to bed and we will never get satisfactory home rule because no one will understand where we want to go. Every year, we will have another argument about which specifics should be included.

We are trying first to set out a destination—although it might take some time to get there—and then to examine the specifics. We have set out a lot of specifics in the past. As you know, I chaired the devo plus group.

On a technical point, the arrangements for the Basque Country are not what we are proposing. The Basques do not raise what they spend—that is full fiscal autonomy.

Professor Trench: That point was not addressed to you, Ben; it was addressed to the committee. I am aware that that is not what you are proposing.

Ben Thomson: That is not the raise-what-you-spend model. Under the raise-what-you-spend model, each level of government—which I hope would be Westminster, Holyrood and local government—should raise the money that it spends. We believe that that mechanism makes people really accountable to the public that they serve and gives them the holistic tools to produce the outcomes that are expected. If the outcome for Holyrood is to do things such as get people back into jobs and provide poverty alleviation and housing, Holyrood should be given the tools to do the job. I would argue exactly the same for

Westminster and for local government. It is a similar philosophy all the way through.

When it comes to specifics, we can give just as many details in our research as there are in devo more, but devo more cannot tell you what the ultimate destination is; it just says, "Here are some useful further powers to come down." We are trying to put that into a framework and a context. I disagree that the specifics are the important part. The principles are the first step; the specifics come after that.

The Convener: Professor Trench is keen to come back in.

Professor Trench: With respect, I just wish to make one small point. Devo more is as clear as we can be about the destination, given that it is not for that project to define what the destination is. That project has sought to establish what you would need to do, if you were to start from where we are today, to run a more devolved United Kingdom. Those are the parameters that have come out of the referendum, it seems to me. We claim credit for being wise before the event.

The Convener: The campaign for home rule's paper says:

"Both Westminster and Holyrood should have the powers to change, create or abolish taxes for which they are responsible."

Do you agree with that?

Professor Trench: Broadly speaking, yes. That is the nature of devolving a tax: it becomes a devolved matter, and you are then able to make all the decisions relating to it. We have seen that in a micro way in relation to stamp duty land tax and landfill tax at the UK level, which are being devolved as of April 2015 and are being replaced by different taxes in Scotland. That seems to be exactly what one would expect to occur if taxes were devolved.

Part of the point of fiscal devolution is to enable you to use those taxes that are devolved as levers and to exercise full autonomy within that sphere.

The Convener: If income tax were to be devolved, should Holyrood control rates, bands and thresholds?

Professor Trench: That is what we have said.

The Convener: Excellent. Ben?

Ben Thomson: Perhaps that is a question more for—

11:45

Professor Trench: I am sorry to interrupt, but I have a couple of caveats on the control of rates, bands and thresholds. There would have to be a common UK definition of income for the purpose

of income tax in order to make it work, and exemptions in relation to pension entitlements would need to be preserved across the whole UK.

The Convener: I will ask you why that should be the case in a minute. Ben Thomson wants to come in first.

Ben Thomson: I have a question for Alan Trench on his scheme. If the Scottish Government is allowed to create, change or remove taxation but it does not have a framework for what it is responsible for, what is the underlying principle? We are saying that the principle should be that it raises what it spends. Within that, if it decides to remove one of the taxes that it has and replace it with another, it knows that the overall framework is that it has a budget of £38 billion—or whatever the budget ends up being if some welfare powers are transferred down—and its responsibility is to raise the money that it spends. If the policy is just about specifics, moving or changing taxes has no destination or point and it is just struggling in the dark. The Scottish Government will just end up having constant negotiations with the Treasury on Treasury models around whether removing a tax will do something specific, but with no destination or principle behind that.

The problem as we see it is that, unless you have a set of principles, the process will not work going forward because you will not know what you are doing with the taxes that you control.

The Convener: Alan, can you comment on your caveat with regard to pensions?

Professor Trench: I simply point out that, in "Funding Devo More: Fiscal options for strengthening the union", there is a 25-page discussion of the principles that relate to taxation within federal and decentralised states.

The Convener: Okay. I will ask a final question on Ben Thomson's paper before we move on to Alan Trench's paper. On the devolution of further powers to Holyrood, you say that, when

"greater powers are devolved to Scotland, the Scottish Government"

should

"seriously consider devolving some of these new powers, as well as some of its existing powers, to local authorities."

What powers do you mean?

Ben Thomson: The same principle applies as in the devolution of powers to Holyrood. One of the outcomes that Alan Trench mentioned concerned housing, and if the matter is to be addressed at the local government level Holyrood should seek to devolve down to local government powers over housing in exactly the same way as powers are devolved to Holyrood. Local government should have the tools to deliver the

outcome. If local government is responsible for providing homes for people, all the tools involved should be passed down to local government because that is an outcome that it has to deliver.

That is just one example. We see no reason why the philosophy of devolution should not be adopted at the local government level as well as at the Holyrood level.

The Convener: If local government had to raise all the resources that it spends, there would be a significant increase in local government taxation, which would have to be compensated for by a reduction in taxation at the Holyrood level. Is that what you are suggesting?

Ben Thomson: Yes, absolutely. It is the same slice of the pie. As you know, we have gone on record as saying that we do not think that Holyrood should have instigated a council tax cap. We think that the power over council tax should properly be devolved to local government and that local authorities should set business rates and seek to raise more of what they spend. If one of the outcomes that local government is responsible for is local protection, the police force should not be centralised. We have set out all those ideas and have said that we should try to match the outcomes for each level of government with the respective powers.

The Convener: Those ideas are great in theory, but people from areas in the west of Scotland surrounding Glasgow go into Glasgow to shop. The rates revenues for some of the local authorities on the periphery of Glasgow and Edinburgh are significantly lower than those for Glasgow and Edinburgh. Surely, that would mean that, under local devolution, resources would have to be transferred as they are at present.

Ben Thomson: I do not think that it would mean that. It would enable different local authorities to compete in different ways and provide what was best for their local areas. Having differences is not a bad thing; it is a good thing because it enables people to play to their strengths, so I do not see local control as a problem. For example, different areas have different business grants to encourage businesses to come to their areas. I do not see the problem with having different levels of council tax or rates, just as I would not see the problem with Scotland having a different rate of income tax from Wales or Northern Ireland. The argument would be exactly the same at the Scottish Government level.

The Convener: Let us switch to Alan Trench's submission. In the section entitled "Impact of further tax devolution on the block grant", you say:

"Two problems arise from the proposed continuation of the current arrangements for the block grant as part of the

package of further fiscal devolution. First is the question of the discretion this gives to HM Treasury."

There are four quite interesting subsections, which I will ask you to expand on. For example, in paragraph (d) you say that

"in the event of any disagreement"

the issue would be referred

"to a UK minister who will seek to mediate the disagreement. If HM Treasury refuses to change its position ... there is nothing the devolved administrations involved can do."

Does that not significantly undermine devolution? Should it be changed?

Professor Trench: I agree entirely that it should. The dispute resolution protocol, as it was originally called, was instigated by the Scottish National Party Government when it was a minority and incorporated into the memorandum of understanding in 2010. Before then, there had been nothing in there to deal with this issue. I strongly suspect that there was agreement on this with the other devolved Administrations, but that there was a limit to what they could persuade the UK Government to agree to. There is a good deal of rhetoric in that protocol about clear negotiations and seeking to avoid disputes, much of which had already appeared in the memorandum of understanding.

There is then the procedure that provides for the panel of a UK minister who has not previously been involved in the issue to be convened. I understand that the 2012 London Olympics is the only issue that has been referred to such a panel—partly, I suspect, because devolved Governments are now of the view that it is of very limited use—and that it found itself shoehorned into the diary of Francis Maude, who was the Cabinet Office minister. A spare minister, as it were, was found who had not been involved and who was neutral between the parties, because the dispute was regarded as being between the devolved Administrations and HM Treasury; in that sense, a Cabinet Office minister was neutral.

The issue was shoehorned into Francis Maude's diary for an hour at 8.30 in the morning. That does not strike me as a particularly serious attempt to resolve a significant and long-standing issue that involved several hundred millions of pounds, as well as a significant issue of principle about the Treasury's ability to revise and rewrite the memorandum of understanding, which is what had triggered the issue in the first place.

Something more robust is needed. It has been needed for quite a long time, but it is certainly needed now. The problems of that are clearly exposed.

The Convener: You go on to say that

“there needs to be extensive reform of the administrative arrangements for the block grant”

and you talk about

“an independent and impartial figure or body to mediate in the event of disagreements.”

Do you have anything specific in mind for that?

Professor Trench: That needs to be resolved between the parties, although there has to be an attempt to find figures from outwith the Governments involved, such as distinguished grantees in other contexts. The parallel is perhaps not very comfortable, but in Northern Ireland there has been particular recourse to judges from parts of the Commonwealth to help to deal with some of the more complicated issues that have arisen. I do not think that there is any need for anyone from outside the United Kingdom in this context, but there certainly needs to be something that goes beyond ministers in the Governments involved being judge and jury in their own cause.

The Convener: You will know that there have been issues with regard to devolved taxes vis-à-vis the block grant adjustment.

Professor Trench: Indeed. I was slightly bemused, when preparing for this meeting, to see the correspondence that you have had and that this issue has remained outstanding for such a long time.

The Convener: Is that likely to be a continued source of friction in the months ahead, as further taxes are devolved?

Professor Trench: It should not be. The 2010 command paper that set out the model of fiscal devolution that is currently being implemented through the Scotland Act 2012 proposed a much messier mechanism for income tax devolution than for the two smaller taxes. Perhaps it was incautiously simplistic in the approach that it recommended to the two smaller taxes. There has therefore been an attempt by the UK Government to resile from a position that it perhaps slightly incautiously adopted then.

Ironically the approach that has been agreed at the level of principle for the block grant with income tax devolution is much more robust. The index deduction approach, as recommended in Wales by the Holtham commission, is much more robust. One of the many advantages that that offers is that what would otherwise have been a complicated application of the no detriment principle that was proposed as part of the command paper will play a much more limited role, because the change in the UK income tax base will reflect the changes in such things as personal allowances rather than needing to engage in a complex and messy brokerage and negotiation to resolve those issues.

The Convener: In the last sentence of paragraph 8 of your submission, you say:

“Whether such a system is in fact sustainable or durable in the longer term is open to question. (In chapter 6 of *Funding Devo More* I suggested an alternative approach.)”

Could you touch on that for us?

Professor Trench: In the shorter term, we will need to look to improve the machinery that surrounds the operation of the block grant as it currently stands, and to deal with the fact that our financing system essentially depends on an informal Treasury document that the Treasury drafts on its own. There also needs to be greater devolved formal engagement and approval of the statement of funding policy and of its composition, uncomfortable as that will be for the UK Government. If the administration is improved, it will make it easier to then look at other areas.

In “Funding devo more” we recommended an approach that would produce an overall envelope for devolved services on the basis of relative need, and discount from that for the fiscal capacity in relation to devolved taxation. That is an overall approach that would apply no matter what tax basis were to be devolved. The idea of using fiscal capacity in such a context is common in federal systems. In some, like Canada and Switzerland, it is the sole basis of equalisation systems. In others, it is one of a number of components. In a country such as Australia, which, as Professor Muscatelli said earlier, is relatively equity oriented as federal systems go, it still accounts for about two thirds of the changes in the allocation formula that is operated by the Commonwealth grants commission.

Given current levels of spending, it would be necessary to introduce that approach relatively slowly. Such a change would be appreciably to Scotland’s advantage compared with a pure fiscal equalisation approach; when I last looked at the numbers, your overall fiscal capacity was about 98 to 99 per cent of the UK per capita average, and relative need comes out at about 105 per cent. There is an obvious advantage in aiming for an overall envelope that is addressed to relative need. That would need to come in over a period of time. It is not the sort of thing that one could or should introduce relatively quickly.

Ben Thomson: I return to the first point, which is that if you do not have a clear set of principles, you will be reliant on negotiations with the Treasury. History tells us that negotiation with the Treasury is a dark art that is obtuse and difficult to understand.

To add some flesh to that, let us take something like assigned revenues. In the future, they will rely on a Treasury model to determine how much will be benefiting the assignment of the revenues and

splitting it all up. If you are getting that back from assigned revenues, the actions that you take will largely be due to Treasury models coming up with the figures that you will then get allocated. That is a real dark art in terms of negotiation and it will set Governments in conflict around the impact that something will have on your revenue.

All those things add to complexity and could add to friction between the Governments, whereas, if you have a clear set of principles and understand what you are doing, it means that you do not have to rely on some of the complication that Professor Trench is dealing with. I come back to our principles; if you are responsible for raising what you spend, you do not have to rely on the Treasury determining your revenue levels.

12:00

The Convener: One of Alan Trench's professorial colleagues spoke about Treasury gaming in his submission and in oral evidence to the committee.

Colleagues are keen to come in, but I will ask Ben Thomson one further question. Alan Trench states at paragraph 11 of his submission:

"Since HM Revenue & Customs appears to proceed on the basis that the full marginal costs of devolved tax collection should be borne by devolved administrations, it is hard to see how there is any argument that it should not be fully open to scrutiny by the Parliament or bodies the Parliament designates for those charges."

I take it that you fully agree with that statement.

Ben Thomson: That we should be able to have full scrutiny?

The Convener: Yes.

Ben Thomson: Absolutely. We need clear information. One should be able to see very clearly the figures from across the UK and within Scotland.

The Convener: Do you want to comment further on that aspect, Professor Trench?

Professor Trench: No.

The Convener: Thank you. We move to the open session.

Jamie Hepburn: Professor Muscatelli, who gave evidence in the previous session, stated in his submission that, where there are diverging political priorities in different jurisdictions within a single state,

"a highly devolved system is more desirable."

Do you agree?

Ben Thomson: As I have said, the principle of subsidiarity is totally in agreement with that. The higher level of government has to justify why it

needs those powers to do something on a UK basis, and everything else should be pushed down to devolved government, both at Holyrood and—according to our principle—down to local government. I agree with that statement.

Professor Trench: I agree with the broad principle, but I am not quite sure what it would necessarily mean in practice. The question of what amounts to a large amount of fiscal devolution varies from system to system.

In Scotland's case, we have a Government that is responsible at present for approximately 65 to 70 per cent of the total public spending that takes place in Scotland. The bulk of the exception is, of course, social security spending. That already puts Scotland at the upper end of constituent units in federal and decentralised systems around the world.

What Scotland is not doing is raising any significant proportion of that. The aim of the recommendations that were enacted in the Scotland Act 2012 is to push up that figure from where it currently stands—on the basis of local taxation, I think that it is approximately 14 or 15 per cent—to around 30 per cent. We will see whether it actually accomplishes that. I suspect that it will not, partly because—slightly paradoxically—of the council tax freeze. The Scottish Government has deliberately chosen as a matter of public policy to reduce one source of revenue in order to achieve certain policy outcomes.

There is also a constraint with regard to what one can actually do within the UK tax system. As I said to the committee when I gave evidence previously, the UK is characterised by a very centralised tax system. Indeed, the more I look at it, the more I come to the conclusion that that seems to be the point of the United Kingdom: it was built around a very centralised tax system that goes back to the 18th century or even the 17th century. Moving away from that is no small undertaking. That is not a reason to say that it should not be done, but it is not easy to do.

Jamie Hepburn: Thank you—that is helpful.

I will try to make one composite question out of two. Professor Trench, you refer in your submission to the Scotland Act 2012 and the fact that new taxes could arise from it. I will come back to that point a minute.

Ben Thomson's submission refers to the idea—the convener also mentioned it—of substantial welfare powers coming to the Parliament in a similar fashion to the possibility of new taxes being created. Should those substantial welfare powers allow the Scottish Parliament to create new forms of benefit that might not even have been thought of thus far?

To return to your submission, Professor Trench, you are quite critical—I think that you are, but perhaps you are not and you have just set out a fact—of the criteria that are set out in the command paper entitled “Strengthening Scotland’s Future”, which mean that new taxes require Her Majesty’s Treasury approval. You say:

“these criteria imply a view that new taxes should not be introduced, rather than that this is a matter first and foremost for the Scottish Parliament.”

Is that a satisfactory state of affairs? Both of you can comment on both issues—new taxes and new forms of benefit.

Professor Trench: As far as welfare benefits are concerned, the answer is yes. We said so very plainly in the “Devo more and welfare” report. As part of the idea of a supplementing power, the Scottish Parliament should be free to introduce new welfare benefits if it wishes and provided that it can find the resources to do so.

I was interested to hear Ms Urquhart’s questions to Professor Muscatelli about new taxation. When I read that command paper, which was, admittedly, a little while ago, those criteria struck me as both vague and negative. That is disappointing, given the importance of the power.

The power to introduce new forms of taxation is very important, not merely because that is possibly a way for the Scottish Parliament to raise additional revenue, but because it is a way for it to shape behaviour and perhaps also to obtain revenues from activities that have been encouraged by other means. That strikes me as something that ought to be looked at quite positively, not least because it is part of what fiscal devolution will mean. There will be a different fiscal mix in the different parts of the UK. One would not expect all the parts of the UK to have the same taxes, even if the rates varied. They will tax different things in different ways. That is the point of the exercise.

I hope that those criteria will be clarified in the coming months. The UK Government would be well advised to look at them again, to clarify them, and to cast them in clearer and more positive terms so that the devolved Governments have greater certainty about what taxes are, and are not, likely to satisfy them.

Jamie Hepburn: Failing that, should the Smith commission and the further devolution process make a recommendation in that regard?

Professor Trench: It would be helpful if they did.

Jamie Hepburn: Okay. Thank you.

Ben Thomson: To step back a little bit, the outcome as we see it should be Scotland being

responsible for all the political and welfare levers along with the spending powers for domestic matters. If those powers are devolved down, Scotland should have full control over the welfare and tax powers to deliver the outcomes that it means to deliver.

When a welfare power or tax is passed down, the Scottish Government should have the ability to change it, get rid of it, or create new taxes or welfare powers. We totally support that. That is what having full fiscal levers means, and that is why we are so against assigned revenues, which give no levers at all to be able to influence and change policy. All that people get is a share. Assigned revenues are another form of the Barnett formula, if you like, coming down from Westminster. We do not see assigned revenues as any form of devolution at all.

Under the Scotland Act 2012, only 22 per cent of Scotland’s current budget of £38 billion will be covered by taxes that Scotland raises. If you look at the three proposals that Labour, the Liberal Democrats and the Conservatives put forward before the referendum, you will see that that would go up to 26 per cent under Labour, to 37 per cent under the Conservatives and to 41 per cent under the Liberal Democrats. I have excluded assigned revenues, because we do not believe that they are devolved at all. We do not believe that that represents any sort of matching between fiscal responsibility and spending responsibility, and that is why we have a very clear statement.

I agree totally with Alan Trench that if this idea goes ahead, we will see different mixes of taxes; the main industries in Scotland are not the main industries in other parts of the UK. We rely heavily on things such as tourism, the financial services sector, the whisky industry and the oil and gas sector, so we can construct contracts and taxes around supporting those industries. We are not particularly interested in major international non-domiciled residents, so things such as non-dom taxes are not particularly relevant to us.

We can focus on creating a taxation package that will benefit Scotland’s economy and help it grow, which is part of the outcome of what Holyrood is supposed to do. I very much agree with the different mix of taxes idea. In answer to Jamie Hepburn’s point, I think that once power is devolved in relation to welfare and taxation, the Holyrood Parliament should have full powers to change taxes, create new taxes and get rid of taxes to meet the outcomes that we are trying to achieve.

Professor Trench: Mr Thomson referred to a figure of 22 per cent for the proportion of Scottish Parliament spending that will be raised through the Scotland Act 2012 package. I think that he derived that figure from the recent Scottish Government

paper, "More Powers for the Scottish Parliament". On the face of it, the figure is backed up by some of the numbers in "Government Expenditure and Revenue Scotland 2012-13". However, I really rather doubt the figure and I strongly suspect that there is some double counting going on within it. If I may, convener, I will write to you on that in due course, because I think that the figure is somewhat misleading.

The Convener: We would be happy to receive that information in writing.

Ben Thomson: Is it higher or lower?

Professor Trench: I think that the proportion is appreciably higher.

Ben Thomson: By how much?

Professor Trench: There is double counting on the expenditure side that appears not to be taken account of in the figures that are used to assess Scottish Parliament spending in the GERS data.

Ben Thomson: I am very happy to give you the source of the figures, convener. Scottish public sector expenditure 2012-13, as reported by the Scottish Government in GERS—

Professor Trench: The point is that—

Ben Thomson: —is £38.546 billion and the income raised through the 2012 act powers, as estimated from the 2012-13 figures, will be £8.669 billion.

The Convener: I am happy to accept any clarification and double checking of any of those figures.

Professor Trench: There is some double counting in that 22 per cent figure and it is a mistake to take the figure at face value rather than understanding exactly what it does and does not include.

The Convener: Jamie, the ball is still at your feet.

Jamie Hepburn: I am delighted about that. This discussion is very interesting, if somewhat theoretical. The exact proportion of what the Parliament will raise out of the 2012 act is not exactly the talk of the steamie—or it has not been raised with me by constituents, I should say.

Professor Trench: That sounds like a sad comment on the decline of Scottish public debate since the referendum campaign.

Jamie Hepburn: It was a comment on something, Professor Trench. I will leave others to conclude what that might have been.

Professor Trench, you argue in your submission that, in the event of further substantial taxation devolution, HMRC should be the primary collection

agency. I was a bit perplexed about why you felt that Revenue Scotland taking on that role would

"increase the burden on taxpayers while reducing the effectiveness of tax collection",

especially given that—as we explored with Professor Muscatelli—one of the reasons for Revenue Scotland being established was that, when the Scottish Government explored the possibility of HMRC collecting the tax that had been devolved, that option was not more cost effective. It would have cost more. It was more cost effective to create Revenue Scotland and charge it with that task.

Professor Trench: I am sure that that is the case for landfill tax and stamp duty land tax or land and buildings transaction tax, and I am sure that the committee has done far more work on that.

In relation to income tax, I was interested in Professor Muscatelli's discussion of the possible need for everyone to submit tax returns. At the moment, we are in a situation that creates something of a dilemma. In most of the developed world, everybody has to submit a tax return at the end of the year—even if, in reality, all their taxes have been paid. When I lived in the United States, submitting a tax return was something one had to do. It was an annual chore, even though my US income was very straightforward. One had to sit down, make sure that one had got it right and then send it off. In my case, I received back a cheque from the Internal Revenue Service.

12:15

In the UK, we have the PAYE system. If you look at that comparatively, it is a wondrous thing. It makes tax compliance on the part of taxpayers amazingly straightforward, because most people do not fill out tax returns. That saves taxpayers a lot of time and inconvenience. PAYE also provides for a very high rate of tax collection, so the public revenues received are a very high proportion of what the Government is entitled to. That rate appears to fall off by about 10 points once there are systems that are submission based. Indeed, when self-assessment taxpayers are compared with PAYE taxpayers, the rate of payment is about 85 per cent as opposed to 95 per cent. In addition, the PAYE system is much cheaper and simpler for the tax collection agency.

The question that needs to be asked is whether Revenue Scotland could operate a PAYE system that dovetailed with HMRC's system in relation to Scottish taxpayers. That would depend on a number of things, including the extent of income tax devolution and how that interacts with non-devolved tax. For example, not many people pay capital gains tax and it is not a large amount of

revenue, but it must be accounted for and that happens through the income tax system. In addition, how would the interrelationship be managed between people who change their tax residence from one year to another so that they count as Scottish taxpayers in one year but not the next or vice versa? Furthermore, how does one ensure that one has control of the information to provide at least some check on the accuracy of the information that taxpayers are providing? Those are the operational considerations.

There are also strong arguments for HMRC to continue to operate as a tax collection agency. In many federal systems, a central state agency carries on doing such things. I am always struck by the extent to which tax collection in Canada remains in the hands of the federal Government except in Quebec. In English-speaking Canada, the line that I often hear when I ask about that is, "Well, on the one hand, that is what the federal Government does to make life easy for Canadians." That is the line from federal Government. The more general line—not just from the people in federal Government but from others who are involved in the tax system—is that that seems to be Quebec making life difficult for Quebecers in order to make a nationalist point. That consideration would apply if you wanted to have a different tax collection agency for income tax in Scotland.

Ben Thomson: There is a huge opportunity in devolving tax collection. That opportunity could be for both countries to provide a better service. I agree that PAYE has worked quite well, but the services around that and people having to filling in their tax returns are not particularly good. HMRC has the lowest staff morale feedback of any Government department. That is an indication of how the organisation is run.

There is a huge opportunity to provide the service and, if Scotland had a full range of taxes, to simplify them. Tolley's, the tax guide, has doubled in size in the past 15 years and the font has gone down from 12 points to 10. The issue is not just about the levels but the simplification of taxes. Therefore, if different parts of the country are doing it differently, we can learn how to do things better in terms of simplification and in the service that is provided to the customer who is trying to pay.

Malcolm Chisholm: Approaching the issue from first principles is helpful, irrespective of whether we agree with those principles. I will home in on what I take to be the central principle of the campaign for Scottish home rule, which is that fiscal and spending responsibilities should be aligned. Professor Trench had something interesting to say about that towards the end of his paper, where he challenged that on equity

grounds. We will leave that to one side for one moment. He also said that it is hard to see how that alignment could be achieved.

I am trying to get this clear in my head. Professor Trench seems to be saying that, even if it was desirable, that alignment cannot be done, whereas Ben Thomson's group is saying that it can be done. I would have thought that it would be a matter of objective fact rather than a matter of opinion. I am slightly puzzled as to how Ben Thomson thinks that he can do it, as he is strongly against the assignment of revenues, which other people say we would have to throw in to get anywhere near the requisite amount. Can we try to establish some facts around this? Perhaps Ben Thomson can say what suite of taxes would raise all the money that we spend, including the welfare element that he supports.

Ben Thomson: At the moment, according to 2012-13 figures, total public sector expenditure in Scotland is £65 billion, which is financed by £53 billion of tax raised in Scotland. The remaining £12 billion is Scotland's deficit, and that is funded at UK level through debt. Scotland's deficit has been better than the UK's deficit in five out of the past nine years and worse in the other four of those years.

There is an overall pie of revenue that is generated in the UK, of which 80 per cent comes from taxation and 20 per cent comes from borrowing. There is then an expenditure pie of which 60 per cent is delegated to devolved Scotland and 40 per cent is spent at UK level. The pies match, so there is no magic about it—the issue is how the pies are split up, and at the moment the pies are split in very different ways. The expenditure pie is split 60:40, and 20 per cent of that 60 per cent is revenue raised in Scotland.

We suggest that the different taxes be changed so that the two pies align, which could be done by devolving certain taxes. Part of our consultative process is about which of the current taxes we want to devolve. Should we devolve national insurance? VAT is probably one to leave at UK level. Should we devolve capital gains tax and inheritance tax? How much of the debt funding—the £12 billion—should be passed down to Scotland? We have devised formulas for how the debt funding should work.

I do not see any theoretical problem in saying that the two pies equal each other—it would just be the case that we would be reallocating responsibility for raising certain bits of the revenue so that it matches the expenditure.

Malcolm Chisholm: Let us leave aside the equity arguments and focus on the practicalities. Why does Professor Trench think that it would be hard to achieve?

Professor Trench: Ben Thomson avoided addressing the specifics. Which taxes are to be devolved? If you are, hypothetically, going to fund the public spending in Scotland that is the responsibility of the Scottish Parliament—my figure is 65 per cent, based on last year's data—where are you going to find the revenues? There is no use in arguing about capital gains tax, which is a tiny source of revenue. We have to look at the major sources of taxation, which include personal income tax, VAT, the two forms of national insurance contributions—which I argue are two rather different taxes—combined alcohol and tobacco duties and local taxation, which is devolved already. If you want to quibble, you can throw into that mix fuel duties and corporation tax, both of which raise about 5 to 6 per cent of the overall tax revenues, which means that they are useful but not crucial to the argument. You must look at the big tax revenues—the two forms of national insurance contributions, local taxation as it currently stands, personal income tax, VAT and perhaps North Sea oil revenues. Those are your big sources of tax revenue.

The North Sea oil tax would, of course, be predicated on Scotland's receiving a geographical rather than per capita share. There would then be a big set of arguments about control of the licensing regime, and that ties into an argument about corporation tax. That is why it cannot be done, I am afraid.: I cannot make the numbers work.

Malcolm Chisholm: Okay. I guess that we will just have to disagree on that. You probably disagree even more fundamentally about the equity argument. You said that an element of the block grant, if we can still use that term, was important as an expression of solidarity across the UK. I suppose that we heard one counterargument from Professor Muscatelli, so would an equalisation fund be possible even within the model that Ben Thomson outlined? The question to Ben Thomson is then this: what about solidarity and equalisation?

Professor Trench: I am not sure that an equalisation fund would be possible. It would certainly be able to do very little, which in turn would mean that a wider UK role in relation to Scotland and its public finances would be significantly attenuated. The question then is whether that is compatible with the referendum result.

Ben Thomson: I have, as part of the consultation that the campaign is now taking out to the public—I shall certainly send it to you all when it is ready—produced a ready reckoner that sets down all the taxes on one side and all the expenditure on the other. There is a little chart at the bottom; you can change the relative

percentages of taxes and welfare benefits and at the end it will show you how close you are to 100 per cent. I tested it out on my family and they all managed to get to 100 per cent and they are only teenagers, so it is perfectly possible. It is a fun game to try but it is totally possible to make the cakes work, and I hope that the game will be available next week.

Professor Trench: I would be interested to see that. You can play it as a game but—I am sorry, Mr Thomson—this is not a game. This is a serious matter of dealing with public administration and a fiscal system that is well established, highly concentrated and subject to a variety of legal constraints. For example—as I mentioned to the committee when I last gave evidence—you would, thanks to the Treaty of Union, be in serious difficulties with devolving excise duties. As part of a devolution process, we would have to decide whether the Treaty of Union is to be amended.

There are also further tangles with European Union law in the form of state-aid law, notably in relation to corporation tax and other taxes, and in relation to the requirement for a single VAT.

You cannot simply play a game that wishes away those constraints because this Parliament and the UK Parliament will be bound by them.

Ben Thomson: Thank you for the interruption. I am perfectly aware of that, and the game incorporates the fact that there are certain taxes, such as VAT, that you cannot change because at the moment they do not work under European legislation.

The question that Malcolm Chisholm asked was about an element of solidarity and redistribution. Let us take the whole idea of home rule across the UK. At the moment, of the £740 billion that is spent on public services across the UK, £430 billion would be associated with home rule activities if England was to have the same home rule as the other three countries in the United Kingdom. That represents approximately 60 per cent of all government expenditure. That would involve a huge amount of fiscal transfers right the way around the UK and, to our mind, it would distort the responsibility and accountability of Parliaments in each of the four home countries—or three, because there is not yet one in England.

12:30

Under our model, with each of the four home countries raising what they spend, if we allocate the deficit fairly, on a per-head basis across the four home countries, the net result would be that Scotland breaks even over an average of the past five years, because the Scottish deficit is roughly the same as the UK average deficit. Wales and Northern Ireland are about £10 billion under. It is

difficult to get those figures. Wales has not broken down its Government expenditure and revenue figures since the 2010-11 figures, so we cannot be totally accurate, but the sum is about £10 billion—we could call it £15 billion. England is a net contributor of about £10 billion or £15 billion, which goes to Wales and Northern Ireland.

With the home rule that we suggest right across the United Kingdom, that would be the result. In the context of the UK, £15 billion is about 2 per cent. In order to get a redistribution—solidarity, if you like—across the UK and keep the no-detriment principle—that the situation should be no different from where we started off—there would have to be a redistribution of about £15 billion, which is about 2 per cent of total expenditure in the UK. With that 2 per cent, we could have across the four countries within the UK an economic and needs-based fund to help areas that run into economic difficulty or which need help with poverty alleviation, based on the methodology that Holtham put forward in his report.

I asked a number of people whether, if Scotland did fantastically well, say though oil, people would feel comfortable contributing 2 per cent or maybe a little bit more to help other people, principally in Wales or Northern Ireland—although who knows what might happen to England going forward. Conversely, I also asked whether, if Scotland ran into problems—let us say because oil revenue disappeared and we needed some help—others in the United Kingdom would contribute. It comes down to degree. If the amount was 2 or 3 per cent of the total budget, people would not feel that there was a problem with contributing to a solidarity fund across the UK. Such an amount would be enough to redress the balance, based on current figures. What we are trying to avoid is the current huge fiscal transfers, which mean that 60 per cent of expenditure at local level is funded from Westminster. Those fiscal transfers take away responsibility and the levers to do things in different economic parts of the United Kingdom. We can achieve solidarity at Westminster level through a central economic and needs-based fund to alleviate poverty. That could be a perfectly acceptable outcome and it is what Westminster should be doing.

Malcolm Chisholm: If there was a macroeconomic shock that affected Scotland differentially—the example that is often given is declining oil revenues in the long run—do you seriously think that the rest of the UK would just think, “Oh well”? Is that what you are suggesting?

Ben Thomson: Three events could happen. One is a disaster. Let us say that a nuclear bomb fell on London. Would we in Scotland be prepared to contribute a serious fund towards helping out another part of the UK? I think that most of us in

Scotland feel that if another part of the UK ran into a significant problem, we would absolutely go and help out, in the same way that, if another part of Europe or even another part of the world ran into a serious problem, we would help out, because that is in the nature of being part of a global society.

Secondly, what would happen if a part of the United Kingdom ran into economic difficulty because its major industry was undermined. That is where the economic development fund would work. That approach works in Europe; half the budget that we put into Europe goes into an economic development fund to help regions that need their economies to be improved.

Thirdly, there is poverty alleviation. Some parts of the United Kingdom, just as some parts of Europe do, need assistance. That would be done based on needs, and that can be reviewed. One would not want to review it every year, because it could become a sort of diminishing responsibility, but the needs of parts of the United Kingdom could be reviewed on a five-year or seven-year basis to see where there are problems.

In that way, the fund could achieve what we seek, which is solidarity across the UK, but would represent a relatively small element, compared with the massive fiscal imbalances that happen whereby 60 per cent of the money is churned round the system through the centre.

Malcolm Chisholm: Does that satisfy your concept of solidarity, Professor Trench?

Professor Trench: It is not my concept; it is anyone's concept.

I am slightly puzzled by Mr Thomson's comparisons with the European Union, because many of the problems that the EU has faced over the past decade or so have derived from the absence of any effective levers to deal with these things. Mr Thomson's view seems to me to turn the expression of UK social solidarity from being something tangible and meaningful into essentially the same approach that Starbucks takes to paying its taxes, which is that when it is caught out, it pays a bit more.

Malcolm Chisholm: Okay. I think that we will just leave it there. Thank you.

Michael McMahon: I am just trying to understand what is being said. I think that I understand Mr Thomson's principle of spending only what you raise and I understand the point that the debts or deficits are reasonably even over the period. The principle of spending only what you raise does away with any requirement to look at things like indexed deduction approaches and what have you, because you calculate what you raise and you spend that amount. Is that the basic principle?

Ben Thomson: The point is that if the Scottish Government wanted to spend more on a particular area and raise more revenues to fund that, it would be free to do so. It would have full responsibility and accountability for doing what it wanted to do. For example, if the Scottish Government wanted to have state-paid tertiary education, unlike other parts of the UK, it would have absolute freedom to have that, but it would have to balance that spend by what it raised in taxation. It is a perfectly logical approach.

Michael McMahon: Your children were using your ready reckoner—is that built into the calculations or would you have to buy them a magic set to get rid of the Barnett formula at the same time?

Ben Thomson: What the UK and Scotland raise—the segments of the pie—do match. There is £65 billion of expenditure in Scotland, £53 billion of tax is raised in Scotland and there is a deficit of £12 billion. There are different ways of allocating those numbers, but the two pies are the same; it is just about allocating them in different ways so that 100 per cent of what is spent in Scotland is raised in Scotland.

Michael McMahon: So Scotland would have to be allocated its share of debt to pay at the same time.

Ben Thomson: It already pays its allocated share of interest. I think that Scotland's interest budget is about £4 billion a year. We already pay our fair share of the UK national debt at the moment, so we should get our fair share of any new debt that is taken on each year. If the UK's finances became more balanced and we returned to a position where we did not have a deficit, Scotland would have to become more efficient to match the rest of the UK in terms of the deficit.

Michael McMahon: Would some complexity come into the system in that the Scottish Government would have to be asked to contribute if there was to be an increase in the debt that the UK Government took on?

Ben Thomson: No. If the UK Government had to borrow another £100 billion-worth of debt next year, Scotland could be allocated its fair share of the debt, which would be, per head of population, £8.9 billion. If Scotland wanted to raise more debt because it wanted to do more things, such as invest in long-term infrastructure, it could do so according to guidelines, just as local government has guidelines, under the overall monetary policy of the UK. If Scotland wanted to use such borrowing to reduce taxation, it could do so, because it would have the full levers for that. Is that clear?

Michael McMahon: It is clear if you look at it from that perspective. Looking at it from the other

side of the coin, if the UK wanted to increase debt but Scotland did not want to do so, would Scotland have to raise taxes that it did not want to raise in order to pay for the debt that the UK Government had taken on?

Ben Thomson: If the UK raised a lot more debt than was needed in Scotland, and Scotland got its fairly allocated share of the debt, Scotland could either spend more or reduce taxes to match the fact that it was getting the benefit of the debt. If the debt is raised at a UK level, Scotland will still be paying the interest on that debt, so why should we not get our fair share of it?

Michael McMahon: I understand the principle of that, but who is going to make the decisions about the raising of the debt? If Scotland is going to have to increase its expenditure to meet the interest on that debt but does not want to spend the money in that direction, how would you resolve that issue?

Ben Thomson: It is not a decision on the debt. The debt comes out of the deficit. The chancellor in London, George Osborne, will say at the end of the year, "Oh dear, we have a hole of about 20 per cent between what we have spent and what we have raised in taxes, which is about £120 billion, so how am I going to get cash to pay people?" He will answer, "We are going to raise another £120 billion of debt."

We will then have to pay our proportionate share of the interest on that debt—that happens already—and so, at that stage, we should get coming down to us whatever that share of the debt is. If Scotland has done very well because we have done things very efficiently and have grown our industries, that means that we will get a benefit, and we can either spend more or have lower taxation. That is all to the good.

Michael McMahon: It all sounds very simplistic as well.

Ben Thomson: But there must be a floor—

Michael McMahon: Professor Trench, in looking at some of the taxes that could be either devolved or assigned, you say that you do not think that oil and gas revenues are suitable for either. You say that that is primarily because the receipts

"are determined by such factors as the extraction rate and global oil prices".

However, the UK does not have control over extraction rates and global oil prices, so why would the lack of control be a barrier?

Professor Trench: No, it does not, but the UK has two advantages when it comes to dealing with that. One is that the UK is a lot bigger. The other is

that the UK has, and would have on any basis, access to a much wider range of tax bases.

If we go through the list of taxes and their revenues across the UK, we notice that there are a large number of taxes that generate individually only small proportions of revenue but which cumulatively add up to quite a lot. That is one of the means by which the UK Government is in a much better position to balance the wider range of risks that come with a highly volatile stream of revenue, such as North Sea oil and gas. It is simply that volatile things are better managed at a higher level by someone who can spread the risk more evenly.

Michael McMahon: I accept that, but in your paper you seemed to be making the argument on the principle that the extraction rates and global prices would not be under the control of the Scottish Government and saying that that is why oil and gas taxation should not be devolved. The argument now is that it is better handled at the macro level.

Professor Trench: I am sorry if my argument was misunderstood. I entirely agree that the reason is that it is better handled at the macro level, particularly when it is being looked at as a source of revenue—and it would have to be looked at as a source of revenue. Government funds public services that have a rather annoying spending profile of being both generally inflationary and counter-cyclical. The spending profiles of both health and education are that they go up all the time but particularly when times are bad. To help balance those costs, you want a stable source of revenue, rather than one that is counter-cyclical. Alcohol duties, ironically, appear to be the only tax that fits that bill.

John Mason: Professor Trench, you commented on full fiscal devolution in your submission from June 2014, which said that

“It would be incompatible with anything like the existing UK welfare state”

and that

“A referendum vote for Scotland to remain part of the UK therefore also has to be regarded as a rejection by Scottish voters of the idea of full fiscal autonomy.”

Do you still hold to that? Do we know why people voted no in the referendum?

Professor Trench: You were actively campaigning in the referendum, no doubt, and I was not, so in that sense you are in a better position to know. What we do know is that people voted to remain in the United Kingdom on the basis of the United Kingdom remaining intact but with further devolution along the lines that the pro-UK parties had indicated through their various

schemes—if people had dug down into that level of detail.

12:45

John Mason: As you suggest, I spoke to people, and my impression was that there were a variety of reasons why people voted no. I therefore find it difficult to say that, because they voted no, something else is clear.

I am particularly interested in the welfare state and pensions. As I understand it, Scotland spends approximately the same as the rest of the UK on social protection—that is, pensions and benefits together—so devolution of all pensions and benefits would not cause a big problem.

Professor Trench: From my recollection of the figures, that is not quite right. It is a little while since I looked at them, but I recollect that the overall level of welfare spending in Scotland is slightly—but only slightly—higher than that in the UK as a whole, on a population-share basis. Therefore, there is a slight extra level of payment within Scotland.

John Mason: Is that just for benefits, excluding pensions?

Professor Trench: No, that is for the overall budget. As I said, it is a while since I looked at the figures.

There is a particular issue for pensions that relates not to current payments but to demographics and the age profile of the Scottish population, and that is likely to cause a significant further burden in paying public pensions in the coming two or three decades.

John Mason: Do you mean that our people die earlier and, if they start to live longer, they will need more pensions?

Professor Trench: That, and that you have more middle-aged people who will be claimants and fewer younger people who will be able to work to pay for those pensions.

John Mason: Unless we can solve immigration.

Mr Thomson, you also refer to pensions in your submission. You say:

“Even if only those welfare powers that were linked to existing Holyrood responsibilities were devolved (with the main exception of pensions, maternity/paternity pay and free TV licences ...)”.

Does that mean that you do not believe that those should be devolved?

Ben Thomson: As part of our consultation, we are asking people about those areas. However, there seems to be more of a dividing line and a resistance to moving pensions and maternity

benefits, and there seem to be two reasons for that.

First, the future demographics of pensions look particularly difficult. As you are aware, public sector pensions are, by and large, unfunded, as is the state pension—unlike in other countries such as Australia, which are starting to fund their pensions—so they are a major future liability. People have real concerns about the state of that liability, and having pensions in a greater collective gives them greater assurance than having them split up. We have our pension funds with large companies rather than small ones because we get a benefit from the size.

The second reason is that, if people move between different parts of the UK over a lifetime, having the state pension controlled by the UK provides some consistency and assurance that it will be the same. There is a simplicity argument.

There are some good arguments for why pensions should remain at the UK level, but we have not ruled them in or out for devolution because the consultative process that we are undertaking is partly about examining the issue and asking the public about their attitudes towards the specifics behind the principle.

John Mason: Is the issue important because people want their pensions to be the same as they are in the rest of the UK, or is it just that they are afraid that they might be lower than they are in the rest of the UK and, if they were higher, people would be perfectly happy to have separate pensions?

Ben Thomson: If we look at voting intentions in the referendum, people of retirement age certainly seemed to have more concerns about what would happen in future, and one of the big factors for them was the uncertainty on pensions.

Proper consultation is needed on people's attitudes towards pensions and their future demographics, and that is part of what we are trying to do at the moment. We are trying to find out what powers people think would rest more naturally with the UK. I have given you a couple of arguments that people make on why pensions should remain a reserved matter.

John Mason: Was it you, Professor Trench, who used the phrase "UK social solidarity"?

Professor Trench: Indeed. I certainly agree that pensions are a key element of a UK social union.

John Mason: Is that because people are afraid that their pensions might be lower if they are not funded jointly?

Professor Trench: It is on the basis of a matter of principle.

John Mason: Would people not want higher pensions?

Professor Trench: I am sure that people would like higher pensions. The "Devo more and welfare" recommendations would possibly enable people in Scotland to have higher pensions. That would be a matter for the Scottish Parliament to determine. However, the idea of a UK state pension that is payable to all who have made the necessary contributions during their working lives and which they can receive no matter where they live seems to be a fairly key element of being a citizen of a single country, rather than of multiple countries.

To elaborate on the point about the possibility of higher pensions in Scotland, I note that it would be open to this Parliament to determine that by using the supplementing mechanism that we propose. It would be open to this Parliament to decide that some or all pensioners, depending on such criteria as it saw fit to specify, would be entitled to higher levels of payments. That could be done directly, by means of a supplemental pension, or through some sort of additional allowances in other areas. Of course, the pension is not the only benefit that goes to older people; there are also things such as the winter fuel allowance, the over-75s TV licence and so on. That would become a decision for people here to make.

As Ben Thomson rightly says, a key element of labour mobility is that a person's ability to decide where they will take work and spend their working life is independent of the pension that they will receive. A person knows that their UK pension will be available to them even if they were born in Kirkcaldy and educated in Bangor in Wales, they worked in Bangor in Northern Ireland and then in Bognor Regis, and they then decided to retire to Hunstanton.

John Mason: Is that purely because the pension is unfunded? If someone worked in local government, their pension would be fully funded—in Scotland, although perhaps not in England—and they could move around, because their pension would be in a definite pot. Would things change if we moved towards a funded system?

Professor Trench: One's benefits in pension schemes such as the local government pension scheme and the university superannuation scheme, which are fully funded, at least in principle, get frozen if one is no longer working in the service. That is somewhat different. I think that the USS works UK-wide and the LGPS operates in Great Britain but not Northern Ireland, but I may be wrong about that. There are important elements of flexibility in those areas of public service, as there are with the medical pension scheme and the teachers pension scheme. However, those are occupational pensions, which is something different.

There are some quite strong arguments for moving to a wholly funded pension scheme, but we would have to work out how we would get to there from here, which for a long time has defeated almost everybody who has tried to work it out for public pensions.

Ben Thomson: There are two things here—the state pension and public sector workers' pensions—and they are different. The state pension is totally unfunded, although national insurance was set up to fund it. There is no fund of any substance that pays out for the state pension. Some public service pensions are funded, but very few of them are fully funded to meet the liability of the final salary pension scheme. Theoretically, if we could fund them, we would not have a problem, because everyone would have their own pot of money, which would go—

John Mason: Wherever they went.

Ben Thomson: Wherever they went.

John Mason: Even if they retired to Spain or wherever.

Ben Thomson: Exactly.

John Mason: In your paper, you talk about an idea that we have already touched on—the sharing of resources if one part of the UK is not doing so well. Your paper says:

“Part of the responsibility of such a shared UK-wide monetary and fiscal regime should be to ensure that areas of the UK with economic or social difficulties should have access to support through re-distribution and that Scotland contribute its fair share”.

How does that tie in with an area that does well, attracts tourists and business and is more successful? Would all the benefits simply be taken away to the area that had been less successful?

Ben Thomson: I think that I answered that question earlier. It is an issue of quantum. On the current figures, it would take about 2 per cent of total public sector expenditure being redistributed among the four home countries to achieve equalisation.

John Mason: Is it a wee bit of a fluke that that figure is so low at the moment?

Ben Thomson: No. Part of the reason is that England is such a large part of everything. When those powers come down to Holyrood, it will have to think carefully. If it is going to devolve powers to local government, the same redistribution argument will apply. How does one ensure that a rural area with economic difficulties, for example, receives some redistribution from a wealthy area in Scotland?

The reason why the figure is so small is that the populations of Scotland, Northern Ireland and Wales represent only about 15 per cent of the

UK's total population. That means that, if people are looking for home rule across the four countries of the United Kingdom—that is the solidarity principle—a relatively small redistribution fund will be needed to help with economic development or poverty alleviation in areas that need it.

John Mason: I take that point. My concern is about what will happen if Scotland does quite well and the north of England, let us say, does quite badly. That would be a big area for us to try to bail out.

Ben Thomson: I come back to the quantum. If you are asking me whether I would mind 2 or 3 per cent, or something less than 5 per cent, of total public sector expenditure going into the redistribution of wealth, I think that people would say that, if Scotland did fantastically well, they would not mind contributing something to the rest of the UK. That does not need to go hand in hand with a 60 per cent redistribution of money through fiscal transfers whereby the money goes into the centre and then back down locally.

John Mason: Finally, I touch on your suggestion about local government and the idea that we should push subsidiarity down the way as well. I think that many of us are sympathetic to that suggestion. As we are saying that Scotland should be allowed to choose whether it wants this tax or that tax, would you go as far as allowing local government to choose which taxes it has? Should we allow local government to say that it wants the council tax, or a tourist tax instead of the council tax, for example?

Ben Thomson: Yes. The principles are exactly the same. The Scandinavian model has been talked about a lot, and one thing that has been so impressive about that model is that many more powers have been pushed down to a community level. There are 400-odd local communities in Norway and the same sort of number in Sweden.

John Mason: That is exactly my next point. What size should a community be? Is there a right answer to that? We have small authorities such as Clackmannanshire Council and big ones such as those in Glasgow and Lanarkshire.

Ben Thomson: To some extent, that comes from history and local communities themselves deciding the size of their community. Orkney, for instance, sees itself as very much its own community. It is much smaller than Edinburgh or Glasgow, and it works perfectly well. It is one of the few areas in Scotland in which all the regions overlap—policing, health and local government—which has meant that more holistic programmes can be created to solve problems. That is not necessarily true for other parts of Scotland.

John Mason: People might feel that their community is Hamilton, East Kilbride or

Rutherglen rather than South Lanarkshire, for example. We can potentially push further down, below the council level.

Ben Thomson: Yes. It is important to get as far down as we can. We might find that certain communities prefer to be part of something bigger and others prefer to be smaller. The size can become too much of an issue. It is really a matter of what the community wants. If a community wants it, subsidiarity should be passed down to the lowest level of government that wants to take on the responsibilities for achieving outcomes that are suitable for it to take on.

John Mason: Thanks very much.

13:00

Gavin Brown: I think that most of the issues have been covered, but I have some brief questions. The first is for Professor Trench. When you talked about block grant adjustment, I found your suggestion of impartial mediation attractive. However, in order for that to work, whoever was making the decision would have to be completely impartial and to have incredible knowledge of the inner workings of the financial system and sufficient gravitas for everyone to abide by the result. In your view, do such people exist?

Professor Trench: I suspect that they do not exist as single individuals and, if they do, they will be greatly in demand.

The institutional mechanism that most closely corresponds to that is the model of the Commonwealth Grants Commission in Australia. There is a good deal about the commission and the system in which it operates that I am not wholly impressed by. The level of detail that the Australian system requires and the way that it equalises is not ideal. However, the Commonwealth Grants Commission is an impartial commission. It is established under a federal statute and it is technically merely an advisory body. It has about eight members. The previous chairman—a man called Alan Morris—came and gave evidence and took part in various meetings here during the work of the Calman commission.

The members come from various backgrounds, having been in Government—as both politicians and civil servants—the private sector, academia and so forth, and collectively they are able to exercise a much higher degree of wisdom. They are constituted formally as advisers to the Commonwealth Treasurer, who is the Commonwealth equivalent to the Chancellor of the Exchequer in the UK. In reality, their advice is not formally binding, but it is analogous to the advice that is given to the sovereign. It is highly authoritative and it has never been departed from.

Gavin Brown: That is helpful—thank you.

If income tax was to be devolved in its entirety, your preference would be for HMRC to work at a national level rather than passing the responsibility to Revenue Scotland. If that were to happen, you argue that there would have to be substantial changes to how HMRC operates and who it is accountable to.

Professor Trench: Indeed. The many problems with the functioning of HMRC have already been mentioned, and I do not think that anyone would quibble with that point. I suspect that your committee is in a remarkably good place to understand the nature of those problems, given your work. HMRC's performance is regularly considered and criticised by a number of Westminster committees including the Public Accounts Committee. However, I still think that it ends up being the best agency out of those that are around to undertake that work.

There is a further point about the nature of income tax devolution that I should perhaps have made earlier in response to a question that the convener asked. An omission from the current schemes has been savings and dividends income. Ideally, we would get to a point where that would form part of income tax devolution, but even if we agree with that as a matter of principle, there are serious operational difficulties with achieving it because, by definition, a payment by way of savings interest or dividend goes to an individual. The tax liability depends on the individual's tax status, which the person paying the dividend or the interest has no means of knowing.

If we were to move to income tax devolution, we would need a system that put that information in the hands of the payer, which in turn would probably increase the compliance burden on the payer of the interest or the dividend.

Gavin Brown: Thank you.

Mr Thomson, I have two questions for you. The first is on the principle of being responsible for raising what you spend. The convener asked whether you believe that that should apply at local government level as well, and I think that you indicated that that was your view.

You raised an interesting point. If we look at the taxes that local government currently collects, we have the council tax, which is about £2 billion, and business rates, at just over £2 billion. Your view is that the council tax freeze should be removed, so council tax would increase. Business rates could probably go up, but I suspect that there would be a limit to how much they could go up, and the total amount would not be much above £4 billion. At present, local government expenditure is between £10 billion and £11 billion. Has your organisation looked in any detail at how that gap might be

plugged? What sort of taxes are you talking about, or is it more a general principle at this stage?

Ben Thomson: Funnily enough, there was a very good slide in the lecture that Alan Trench delivered last week that showed where principal taxes come from.

There are three principal sources of tax that really work. Alan Trench outlines them in his paper, and they may be described as “good taxes”. They are taxes on income—employee taxes—taxes on property and taxes on sales. We have all three of those in this country, and in most countries more than 85 per cent of taxation comes in those principal forms. For employees, it is national insurance, income tax and so on. All the rest are pretty peripheral taxes—things such as corporation tax, capital gains tax and inheritance tax are really just the last little bit. Coming back to the two pies that we discussed earlier, I note that it would be perfectly possible for local government, if it so chose, to work in such a way that it matched funding with expenditure using those three taxes.

By way of a useful graph, which I will send to the committee, it is interesting to see how the 50 different states of the US operate between those three taxes. The graph allows us to compare states such as Nevada and Oregon, which are broadly similar and which raise roughly the same amount of revenue. One has no income tax at all and the other has no sales tax at all. They have blended taxes in different ways because that was what their voting public wanted, and it suited their local economies better given what they were trying to do and what society in each of those states wanted.

The range of different taxes in different states enables them to do things in very different ways that appeal to their own local electorates. There is no difficulty in constructing a set of taxes at a local level, in the same way that a set of taxes can be constructed at a Holyrood level, such that the segment of the pie for revenue matches the segment of the pie for expenditure.

Gavin Brown: As regards the principle of being responsible for raising what you spend, a question came into my head just as you were responding. I do not have the figures in front of me, and you might not have an answer right now, but if we stick to the principle of Scotland raising 100 per cent of what it spends, which I guess represents your group’s view, and we add all of welfare and benefits on to current Scottish Government expenditure, that will mean adding £16.4 billion on to the £38 billion. You automatically exclude VAT, which I think would mean removing about £10 billion from the £53 billion.

Ben Thomson: It is £8 billion for VAT, I think.

Professor Trench: The figures that I have in front of me, which date back to 2010-11, say that the figure was £16 billion.

Ben Thomson: For VAT?

Professor Trench: Sorry—it is £7.5 billion.

Ben Thomson: So £8 billion is about the right figure.

Gavin Brown: I repeat that I do not expect an immediate answer to this question but, if we add on all of welfare and automatically exclude VAT, even if we devolve every single aspect of every other tax, can we actually get to the principle of raising 100 per cent? Is it a principle that broadly ought to be achieved, or are you saying that 100 per cent must be achieved in order for your group to be satisfied?

Ben Thomson: That is a good question. You are almost reaching the limits if you do everything in that way and you hold back VAT.

Let us look at the numbers. VAT is about £8 billion, roughly speaking. Let us consider the things that are left. Financial is about £4.5 billion of expenditure. Defence and protection—central agencies—are about £3.5 billion, and then there are things such as Europe and aid. You would be stretching it, and there would not be much left by way of other taxes. VAT would pretty much be the UK tax, if you took out everything. However, it would still be covered.

The Convener: That concludes the committee’s questions. It has been a very lively evidence session. Thank you both for your contributions. Would either of you like to make any final points?

Professor Trench: No. Thank you, convener.

Ben Thomson: I just add that I welcome the Smith commission. It is great that the parties are taking the initiative and there have been so many submissions. However, we would like the commission to come up with some principles rather than just horse trading over specifics, and it would be good to feel that there was cross-party agreement on those principles in the same sort of way as applied in the campaign.

On the specifics, when something is devolved, it should be properly devolved. We do not believe that having assigned revenues is proper devolving. There needs to be full devolution of the tools that are needed to do the job.

The Convener: Thank you for that.

As agreed at the start, the committee will hold the next two agenda items in private session.

13:10

Meeting continued in private until 13:15.

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