



The Scottish Parliament  
Pàrlamaid na h-Alba

## Official Report

# DEVOLUTION (FURTHER POWERS) COMMITTEE

Thursday 5 February 2015

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**Thursday 5 February 2015**

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**DEVOLUTION (FURTHER POWERS) COMMITTEE**  
**4<sup>th</sup> Meeting 2015, Session 4**

**CONVENER**

\*Bruce Crawford (Stirling) (SNP)

**DEPUTY CONVENER**

\*Duncan McNeil (Greenock and Inverclyde) (Lab)

**COMMITTEE MEMBERS**

\*Linda Fabiani (East Kilbride) (SNP)  
Rob Gibson (Caithness, Sutherland and Ross) (SNP)  
\*Alex Johnstone (North East Scotland) (Con)  
\*Alison Johnstone (Lothian) (Green)  
Lewis Macdonald (North East Scotland) (Lab)  
\*Stewart Maxwell (West Scotland) (SNP)  
\*Mark McDonald (Aberdeen Donside) (SNP)  
\*Stuart McMillan (West Scotland) (SNP)  
Tavish Scott (Shetland Islands) (LD)

\*attended

**THE FOLLOWING ALSO PARTICIPATED:**

Charlotte Barbour (Institute of Chartered Accountants Scotland)  
Steve Couch (PricewaterhouseCoopers)  
Bill Kidd (Glasgow Anniesland) (SNP) (Committee Substitute)  
Professor Anton Muscatelli  
Gwyneth Scholefield (PricewaterhouseCoopers)

**CLERK TO THE COMMITTEE**

Stephen Imrie

**LOCATION**

The David Livingstone Room (CR6)



## Scottish Parliament

### Devolution (Further Powers) Committee

Thursday 5 February 2015

*[The Convener opened the meeting at 09:01]*

### Decision on Taking Business in Private

**The Convener (Bruce Crawford):** Good morning, ladies and gentlemen, and welcome to this morning's meeting of the Devolution (Further Powers) Committee. We have received apologies from Tavish Scott, Rob Gibson, for whom Bill Kidd is substituting, and Lewis Macdonald.

Agenda item 1 is a decision on taking business in private. Does the committee agree to take item 3 in private?

**Members** *indicated agreement.*

## Draft Legislative Clauses (Taxation)

09:01

**The Convener:** That brings us neatly to agenda item 2. For this evidence-taking session, our panel of witnesses are Charlotte Barbour, head of taxation, Institute of Chartered Accountants of Scotland; Professor Anton Muscatelli, principal of the University of Glasgow; and Gwyneth Scholefield, director, and Steve Couch, partner, PricewaterhouseCoopers. I am very grateful that they are prepared to give evidence this morning, and I thank them for attending. As usual, my colleagues around the room will ask questions, some of which will be directed at the whole panel and some at individuals. We will just see where that takes us.

I will kick off with a very general question. Now that you have had a chance to see the detail of the Government's draft clauses on taxation in the command paper, it would be useful to hear your views on how they have been drafted, the practical challenges that lie ahead in implementing the new powers and how cohesive they are as a package. I guess that, in effect, I am asking you to make an opening statement. Who wants to kick off?

**Steve Couch (PricewaterhouseCoopers):** Good morning, everyone. I am quite happy to start.

I think that the clauses have been drafted with a degree of consistency with what we have seen in the past, and there is nothing surprising either in their drafting or in the expectation of the further steps that will need to be taken to implement them fully. The one comment that I would make—and this relates to the theme of simplicity that might come through in this morning's session—is that, given that the clauses refer back to previous acts, whether that be the Scotland Act 2012 or various United Kingdom income tax acts, there is a piece of work to be done to make everything simpler, including the language that is used and the communication that will be necessary to get all of this out to employers and the public in general.

**The Convener:** Aside from the practicalities, what about the package itself?

**Steve Couch:** As the document accompanying the clauses makes clear, it is a logical step forward from the Smith commission. It is helpful rather than unhelpful.

**The Convener:** Thank you, Steve. Did you want to respond, Anton?

**Professor Anton Muscatelli:** Thank you, chair. First of all, I should explain that I am here in a

personal capacity instead of representing the University of Glasgow. I believe that I said the same thing at my last appearance.

A number of areas need to be looked at carefully as the command paper finds its way into legislation. On tax and the interactions between the tax provisions and the fiscal framework section of the command paper, I am particularly concerned about borrowing powers, which are not outlined in the command paper. That raises interesting issues, as I think I set out when I was last in front in the committee. If one devolves more taxation powers, how one frames the fiscal framework in the future for the United Kingdom has implications on how the fiscal powers can then be used by Scotland. There are interesting issues there that you may want to explore.

I also have an issue with how the no-detriment clauses might translate into legislation. The Smith commission set out very clear no-detriment clauses but, as the paper recognises, how they are interpreted in practice is quite complex. The paper gives a couple of examples of how that might work with income taxation and adjustments to the block grant. However, as it recognises, that is likely to be much more complicated in practice, so a clear understanding of how it will all be resolved between the two Governments will be required. That area needs to be looked at.

There are other issues, too, such as welfare powers. I appreciate that they will be discussed at some other time, but there are similar interdependencies between welfare changes and the block grant and that will need to be recognised.

On the package as a whole, I will say one thing. When I came in front of the committee previously, I said that, given that it seems clear that there is much greater appetite for greater fiscal autonomy in Scotland, one must avoid creating potential clashes. It is a concern to me that the Smith commission deal reserves the personal allowance and national income contributions. One of the bigger issues for me is in-work benefits. Because universal credit is reserved—I appreciate that you may want to consider that at another session—the whole interaction between welfare payments around low pay and income taxation is not brought into play. That could create tensions. How the situation is managed in legislation will be hugely important.

**Charlotte Barbour (Institute of Chartered Accountants Scotland):** Thank you for having me—ICAS is pleased to be invited.

As an overall comment, I say that the clauses do what Smith sets out to do in the main. There is plenty more for us to discuss as we go along and go further down the line.

The income tax proposals offer a brave and imaginative path between using the existing Her Majesty's Revenue and Customs machinery and legislation while building on the Scottish rate of income tax and bringing further powers into the Scottish Parliament. Smith addresses all three of those issues. On the other hand, given that those three elements are sitting together, the parties will need to interact afterwards, so we might want to return to the allocation of responsibilities.

There is a small bit about capital gains tax. That is just a necessary block to sit with income tax; I do not think that capital gains tax itself is affected, but it is understandable why it is there.

It is fine for the two small taxes to be devolved. They are relatively stand alone and are like those taxes that have already been devolved; they are quite easy to devolve.

The assignment of VAT offers more opportunity for discussions on how that might be calculated. It slots in with the difficulties with the fiscal framework and some of the no-detriment issues. I am not quite sure how you would calculate it. If you take a rather general estimation process, that will not marry up with and give you a true reflection of the Scottish economy. However, the better it marries up with the economy, the more difficult it is to calculate. Such elements might run through how you calculate no detriment.

I will make one other opening comment. The package offers various taxes to be devolved and different types of devolution. We have what I would call full devolution of the smaller taxes, such as the aggregates levy and air passenger duty. Those will come here lock, stock and barrel; they will be switched from Westminster for Scotland. It will not quite be that you can do what you like with them, but you know what I mean. They will be Scottish—full stop.

Then income tax is partially devolved, so there will be joint responsibilities, as Professor Muscatelli suggested. The UK will still have responsibility for a large proportion of it—there is all the HMRC legislation—so Scottish powers will need to interact with that and they will have to mesh together. There is also the welfare side of it, which needs a bit of management.

VAT is completely different because it is an assignment as opposed to having anything much to do with Scottish powers per se. One issue that comes out of that for me is that I am not sure that a lot of people among the public have a full understanding of what Scottish taxes are or the fact that they are different and have different powers attaching.

**The Convener:** That was very helpful. Let us start in the area of borrowing powers—including the no-detriment element—because, from the

indications that we have had about the fiscal framework that will be required later, that is an area that we will have to get into in some detail. Stuart McMillan has a question on no-detriment issues.

**Stuart McMillan (West Scotland) (SNP):** Good morning, panel. The committee has discussed the issue of air passenger duty in the past. If APD is fully devolved and this Parliament gets powers to set rates, there will be competition with regional airports, particularly in the north of England. How does that stack up with the principle of no detriment?

**Charlotte Barbour:** I do not think that that is a technical issue. I do not know whether Professor Muscatelli has views on that, but it is a bit like land and buildings transaction tax versus stamp duty land tax. If you have differentials, that is where it goes.

**Professor Muscatelli:** For all these adjustments, do you adjust initially and then see what happens or do you adjust taking into account second and third-round effects? Let us take an imaginary scenario in which Scotland decides to reduce APD. That would lead to an immediate adjustment because it would impact on air traffic and then, a year or two later, there might be some change in APD in the rest of the UK. It depends on whether you take those second and third-round effects into account.

My feeling is that the issue is less serious with APD because of the point that Charlotte Barbour made earlier—it is devolved fully and it is not a huge amount of taxation. The issue is more likely to be serious with income taxation, because that taxation is just so interdependent. Therefore, an eye will need to be kept on the impact of the second and third-round effects.

I do not want to shift away from APD but, if we look at the discussion on income taxation in box 1, we see that there is an agreement in principle as to how it could all be managed in relation to UK risks and Scottish risks. However, there are then open questions around how it should be adjusted in relation to long-term demographic trends. In a sense, APD is very similar to that. Do you adjust it once and for all or do you take into account other issues later on? It is clearer when it is a fully devolved tax because the argument would be that you would have a once-and-for-all adjustment and, after that, it would be up to Scotland to manage its tax base.

**The Convener:** Let us continue to look at Professor Muscatelli's point about income tax and the no-detriment issue there.

**Linda Fabiani (East Kilbride) (SNP):** I have a related question. I was interested in what Professor Muscatelli said about the issue. It is all

about interaction, but personal allowances and national insurance and so on are not part of the package. People have commented on the fact that a zero rate can be applied—some would say that it is a sop; others would say that it can work well. How do you perceive that interaction in relation to cohesion if there is the ability for that zero rate?

09:15

**Professor Muscatelli:** We will need to see how the way in which it is framed at the moment is translated into legislation effectively. If there is the ability to set a zero rate in the legislation, the personal allowance will, in effect, be devolved, at least in terms of being able to rise above the UK level.

That is just one example of situations that could emerge. Let me give another example of how partial devolution of income tax and national insurance could lead to conflict. The examples that are given at paragraphs 2.4.14(i) and (ii) on page 31 of the command paper, on the no-detriment clauses, are pretty clean. In a sense, they are the easiest examples because they deal with increases or decreases in UK income tax when we are trying to deal with either an increase or a decrease in either devolved or reserved spending. That is pretty clean. We can see how we can have a first-round adjustment to take account of that and ensure that the decisions are as compartmentalised in the rest of the UK or Scotland as possible.

Imagine when there is a change in spending in the rest of the UK that is financed using, let us say, a change in national insurance. We have seen that before with health spending under the previous UK Government. That will have knock-on effects because, although national insurance is sometimes seen as a separate thing, it is part of the whole income tax structure. Not devolving national insurance creates potential for conflict and it will impact on the Scottish tax base.

That is one of the reasons why I would have preferred to see a cleaner allocation of all income tax and employment income powers to Scotland, because it would have avoided that sort of clash. It is an example of how an interaction could create some difficulties for the two Governments in trying to trace exactly who did what and what the impact is on the respective tax bases.

**The Convener:** Would other panel members like to reflect on what Professor Muscatelli has said? Are there any contrary views?

**Steve Couch:** I would not want to get too involved in the set-up of the fiscal framework. That is a matter for the Government and other parties to look at. PWC is looking at the results that come through and how the framework is implemented.

**Duncan McNeil (Greenock and Inverclyde) (Lab):** Your submission says:

“For reasons of legality and practicality, certain taxes are not suitable for devolution.”

You include national insurance in that. Could you expand on the reasons of legality and practicality? Why would what has just been suggested not be suitable for devolution?

**Steve Couch:** We have looked at transparency and simplicity and, when the submission was written, we were saying that the steps would be complicated.

**Duncan McNeil:** Your view has changed.

**Steve Couch:** No, I am not giving any view in what I am saying now. I am referring to your question about our submission at that time and when we were writing that paper. I am not saying that the view is different now. That is what we concluded.

**Charlotte Barbour:** It is very difficult to pull any one part of UK taxes apart. It leads to questions about whether national insurance and income taxes go together. Certainly in the past few decades, ICAS has said that income tax and national insurance might have been married up together because they often look as though they are one and the same. That could lead us in the direction that we are talking about.

Equally, perhaps one ought to stop and have a think about whether they should be the same or whether we want to do something slightly more radical than just work with income tax. All the different taxes, including national insurance in my book, although it might not be in everyone's book, and other policies, are all finely interwoven.

**Alex Johnstone (North East Scotland) (Con):** Under the current Government, there has been a lot of pressure to raise tax thresholds, and that pressure will inevitably continue. However, there is a strong and growing field of opinion that we need to take our eye off tax thresholds and start to look at the impact of national insurance on the low paid. If that had been devolved, would it not offer an early opportunity for an extreme divergence in the application of national insurance at the low end of the wage scale?

**Professor Muscatelli:** Yes. There have been various reviews of the UK tax system, and I would be one of those economists who would argue that we should be trying to marry those things up. One of the biggest issues in income inequality is low pay in work. Much of that is to do with very high marginal tax rates, as I said in a previous submission.

It is a hypothetical scenario, but suppose that national insurance had been devolved. That would

have given Scotland an opportunity to consider it as a whole, and I suspect that it might have triggered a similar review south of the border. Then, there could have been a substantial divergence, which might have led to a change. However it is engineered, I would be in favour of such a change, for the reasons that Charlotte Barbour has alluded to. The two things are getting closer and closer together. The tax structure, or rather the structure of tax plus national insurance in the UK, is hugely complex, with a very strange pattern of marginal rates as we go through the earnings spectrum.

**Charlotte Barbour:** The other point that you need to watch out for, if you are focusing on income tax and national insurance, is that many of the HMRC's anti-avoidance measures in recent years are not just about national insurance versus income tax; they involve that package versus corporation tax versus dividends. Depending where income tax goes, there might be a knock-on effect on family businesses. Individuals who think of themselves as self-employed, however one wants to define that, might want to work through companies, they might pay themselves dividends and head off into UK tax, or they might want to stay with Scottish tax. If there are differentials, that will be brought into play.

**Gwyneth Scholefield (PricewaterhouseCoopers):** What we hear from our clients is that they want the system to be simple and transparent. That came out through the Smith commission recommendations. What is proposed post-Smith is in effect a further development of the Scotland Act 2012. It is a step-by-step approach. Bringing in national insurance introduces complex issues and will lead people to decide—as Charlotte Barbour mentioned—whether they are employed or self-employed and how the interaction should work.

There is a desire among businesses to be aware of the timing of the changes and of how the changes will be communicated, and to keep things simple, taking the changes in step-by-step stages. One of the key messages from Smith should be about sticking to income tax and being very clear about what the changes mean for business and employers as they implement them. Make it simple, make it clear and then move forward on that basis.

**The Convener:** I will come back to Stuart McMillan at the end of this part of our questioning to let him sweep up, as I did not let him come in with a supplementary. Stewart Maxwell is next.

**Stewart Maxwell (West Scotland) (SNP):** I did not understand Steve Couch's comments about national insurance contributions in response to Duncan McNeil's question. In your paper, you say:



"For reasons of legality and practicality, certain taxes are not suitable for devolution."

Could you tell us what those legal and practical reasons are? I did not understand your answer.

**Steve Couch:** We have had some hints of the practical reasons in what has come through in our discussion. Would you like me to comment further on practical reasons?

**Stewart Maxwell:** Yes. I am trying to understand why you came to your conclusions.

**Steve Couch:** When it comes to what can be devolved most easily, if we look at the list of taxes, as we have done, we find that national insurance raises complexities that are not present in the same way in relation to income tax. We have discounted corporation tax, because it raises complexities, too.

**Stewart Maxwell:** I understand that. What about the legal problem?

**Gwyneth Scholefield:** It concerns the linkage between national insurance and welfare. Full devolution would require more clarity about fiscal powers. There is quite a link between the two, and further devolution makes things complicated. According to the Smith commission, welfare and taxing powers sit in two very separate buckets, as I would describe it. Bringing those together through the further devolution of national insurance would be inevitable, as they sit together.

**Stewart Maxwell:** I have to say that I am struggling a bit with this; I still do not understand what the legal problem is. I understand that complexities arise, even with the proposal that is on the table from the Smith commission, as set out in the draft clauses. I apologise if it is just me but, as I said, I am struggling to understand the legal problem. Of course there will be complexities; of course there is the no-detriment argument; and of course—I realise that I am straying into the issue of welfare—there is the question of how changes to welfare made here will affect benefits and whether they will be taken off at the other end. I understand that complexities arise with devolving national insurance contributions, but I am trying to understand what the legal problem is.

**Steve Couch:** I was not involved in writing the paper, but I suspect that it is to do with European law—

**The Convener:** Given that you were not involved in writing the paper, we would understand it if you—

**Steve Couch:** I am happy to give a fuller answer, convener.

**The Convener:** Okay—all that I am saying is that, if you feel that you cannot answer, we can follow up the issue in writing later.

**Steve Couch:** I will follow this up in writing, but what comes to mind is the interaction of social security regulations across the European Union, which involves a different set of criteria in comparison with the interaction of income tax across the EU. For cross-border workers, the social security rules are different from the income tax rules. The rules for a worker abroad who is contributing to a social security system are different from the income tax rules, and I suspect that some of the legal complexity around the interaction of the European Union and UK rules on social security lies behind what our submission said.

**Stewart Maxwell:** I knew that this was going to be complex. *[Laughter.]* It would be helpful to get this in writing.

**Steve Couch:** I am happy to come back once I have looked at the issue.

**Stewart Maxwell:** I am sorry, but I just do not understand what the issue is.

**Steve Couch:** There is a set of social security rules—

**Stewart Maxwell:** I understand the general point, but not the detail of why it led you to your position. It would therefore be helpful to have more detail on that.

**Steve Couch:** I am happy to provide that.

**Linda Fabiani:** I will move away from that issue and come back to the personal allowance aspect of my initial question. The personal allowance has not been devolved, but there is the possibility of setting a zero per cent income tax rate. In that respect, I want to bottom out the interaction not only with welfare but with the no-detriment principle.

To make it simpler for me, let us say that a future Scottish Government said, "Okay, we can't play around with the personal allowance, but given that the UK personal allowance threshold for paying tax is £10,000, we are going to apply a zero rate up to £20,000." I know that this is like looking into a crystal ball, but how would you imagine the no-detriment principle applying in that scenario, and what would be the interaction with welfare?

**The Convener:** Now that is a cracker.

**Charlotte Barbour:** If the Scottish Parliament decided in effect to take the personal allowance threshold up to £20,000, that would be a decision made here in the exercise of the Parliament's share of the powers, and the reduced income that it got would sit here—full stop. I have not got my head completely around this yet, so I might pass the question along the line, but an even more interesting scenario would be if the UK

Government set the personal allowance at a lower level, say—for argument's sake and keeping it in round numbers—£5,000. I do not know how that would flow through, because your calculations might have been based on a £10,000 benchmark.

All the no-detriment aspects would flow through but, interestingly, it would be not just a case of no detriment but a question whether Scotland's taxes were almost becoming hypothecated. Income tax does not pay for the whole bucket of things but, if Scots voted on a particular rate of income tax and the money was spent on education and health, other elements might go elsewhere. Quite a bit is underneath all that, what with the joint responsibilities.

09:30

**Professor Muscatelli:** That is a very good answer.

**Charlotte Barbour:** Thank you.

**Professor Muscatelli:** That is exactly one of the issues that arise. If there was a zero rate, it would represent exactly that—a reduction in taxation in Scotland that would need to be absorbed in Scottish spending. That is how it would work.

A reduction in the personal allowance would be like the example on page 31 of the command paper. The question is why the UK Parliament would do that. Would it be an attempt to reduce taxation and therefore spending—would it be in that territory? That would definitely have an impact in Scotland, because it would almost certainly force the hand of the Scottish Parliament to start a zero rate as, otherwise, we would end up with a really odd tax structure around that.

If income tax thresholds were devolved, one would think that Scotland would have the power to do what it liked, but if the personal allowance were reduced and a different tax structure was imposed at the bottom of the tax band, that would force Scotland's hand. That is where not devolving the personal allowance gets a bit messy, to be frank.

**Charlotte Barbour:** I can give a comparison. I do not know whether members recollect that, a few years ago, the corporation tax rate for small companies was reduced to zero. That was meant to be a reduction in tax rates to encourage business but, in fact, every man and his dog incorporated and there was a loss of tax take, so the whole thing was reversed.

The issue is difficult. It comes back to the point that the tax responsibilities on income tax are shared and, over and above that, income tax interacts with other taxes. There is not a lot of scope to radically change what you have here,

and that is not just a conservative accountant speaking.

**Duncan McNeil:** There is an interesting point about the scope for change in any constitutional arrangement. A radical shift on taxation could mean that people shifted across borders and decided where they paid tax. That would be the same irrespective of the constitutional position, whether it be independence or devolution lite, heavy or whatever. Radical shifts would have that outcome whatever, would they not?

**Charlotte Barbour:** Possibly.

**Duncan McNeil:** Is the situation improved if we have influence through intergovernmental relations and agreements, as we can affect the situation but not tip it?

**Charlotte Barbour:** The issue is about getting a balance and doing what you want to do without tipping the balance through unforeseen consequences.

**Professor Muscatelli:** Critically, the situation depends on what the intergovernmental arrangements are and whether there is enough ability to influence.

**Duncan McNeil:** We have not come on to that yet. In the three meetings of this committee that I have attended, the importance of that has become more and more clear.

**The Convener:** I will let Stuart McMillan finish off this section, and then it is important that we get into intergovernmental relations, which relate to how the fiscal framework will work.

**Stewart Maxwell:** I have one question on the issue before we wrap up on it.

**The Convener:** Okay.

**Stewart Maxwell:** My question is to do with the point that Linda Fabiani raised about the personal allowance and no detriment. Let us assume that the Smith commission proposals come into effect so that income tax is devolved and the personal allowance remains at the UK level. If the politicians in the UK Government go into an election saying that they will raise the personal allowance because they want to reduce the amount of income tax that people pay, and they are elected on that basis and raise the personal allowance, that is a political decision. The UK Government has decided to reduce the amount of income tax that it gets, although it might get taxes from somewhere else—pretty obviously, they would have to be taxes that are not devolved.

In effect, that would reduce the tax take to the Scottish Government. Would it automatically follow that the no-detriment clause would come into effect? Would the UK Government have to pay the balance by raising the block grant element or

would the Scottish Government have to find some other way to deal with that, such as raising income tax somewhere else?

**Alex Johnstone:** The Scottish Government would raise the tax itself.

**Stewart Maxwell:** No.

**Professor Muscatelli:** According to page 31 of the command paper, that would be a decrease in rest-of-UK income tax, and I would expect an adjustment to compensate—that is what the no-detriment principle implies. We cannot have a situation in which the rest of the UK decides to change its taxation and that erodes the Scottish income tax base, as that would go against the no-detriment principle. How that gets implemented is critical.

**Stewart Maxwell:** Is it clear that what you describe is exactly what will happen?

**Professor Muscatelli:** Not at the moment. The process has not been laid out in legislation.

**The Convener:** How is that made clear? Is there an answer to the situation?

**Steve Couch:** The next question that you plan to move on to, convener, probably provides part of the answer. We have identified an issue that we cannot resolve around this table.

**The Convener:** I will let Stuart McMillan sweep up on the no-detriment principle before we discuss the block grant adjustment and how the fiscal framework might best be put together.

**Stuart McMillan:** Ms Barbour mentioned business differentials. It struck me that devolved parliaments and assemblies elsewhere in the world have powers that may or may not be similar to those that we have and those that have been proposed. Is there any evidence of businesses moving from one part of a nation state—from one region or whatever—to another part of that nation state because of a slightly improved taxation situation?

**Charlotte Barbour:** Obviously, the taxation situation will be better in one place or another if there are differentials. I am not sure how much of a driver that is. I ask Steve Couch, who has worked across Europe, to respond.

**Steve Couch:** I can give a straight example. When people move to Switzerland on an international secondment, their choices about where to live are based on the different cantons' approaches. Choices are made in other places. New York has a city tax, so people might choose to live outside New York. There are examples of people looking at what the impact will be within quite a close geography.

**Stuart McMillan:** Okay—quite a close geography.

**Steve Couch:** Do you understand what I mean by that?

**Stuart McMillan:** Yes—that is helpful.

Paragraph 5 of the PWC submission starts with the

“Timing of the introduction of the new rules”

and goes on to talk about

“plans to implement the changes already in Scotland Act 2012.”

How will what Smith proposes affect what has passed beforehand when the changes are fully rolled out in Scotland? You discuss the issue of your clients preparing for the rules that are coming from the 2012 act.

**Gwyneth Scholefield:** Our clients are preparing for implementation of the Scotland Act 2012 and the possible changes to rates in 2016. They are using their experience of real-time information and preparation for auto-enrolment to communicate with their workforces and get their payroll and their systems right. They are looking at their policies to ensure that they are consistent with the changes that will happen, and they are looking at how they will manage that. It is clear that employers and employees need time to make those changes, work them through and communicate them effectively.

With the changes that will happen post the Smith commission, we can see that businesses will be uncertain about when they will happen and how businesses will implement them in time. Businesses generally need a lead-in time to get their systems correct, to communicate across their workforces and to work out what the additional administration burden will be for the changes initially, if not in the longer term, and how they will plan for that.

**Stuart McMillan:** We have certainly heard this morning that what has been proposed is not a huge change. As we have heard, income tax, for example, is interwoven, but the change will not be huge. You have used terms such as “administration burden” and “uncertainty” but, because the change will not be huge, there should not be as much of an amendment or an additional burden, to use your terminology, as a consequence of Smith.

**Gwyneth Scholefield:** From the experience of real-time information and auto-enrolment, it is important to note that we have tended to find that, in effect, there have been different deadlines for different types and sizes of employers and complexity. That has almost been a way to embed

the change and to learn what the practical issues are.

The embedding of the Scotland Act 2012 change is almost a forerunner for the post-devolution and Smith commission changes in learning what the practical issues are. Generally, there are tweaks along the way to make things practical for businesses and their employees. Things have been tried and tested through those changes.

**The Convener:** I have a supplementary question. Are you arguing that the Scotland Act 2012 changes should not be implemented in 2016 and that we should wait until we see what the Smith changes are like? I want to be absolutely clear, as that is the logical end of your argument.

**Gwyneth Scholefield:** No. I am sorry; obviously, I misled you. I am saying that letting the 2012 act changes come through and learning the practical lessons from them to have enough lead-in time to build them into the Smith commission changes is probably the right thing to do and is probably what businesses would cope with. However, the timing needs to be clear, as does when businesses will know what the changes are. That is a communication exercise as well.

**The Convener:** So you are saying that it is a matter of learning from the 2012 act before we implement the Smith proposals.

**Gwyneth Scholefield:** Exactly.

**Charlotte Barbour:** ICAS completely supports that. It is absolutely right that some of the processes are not difficult; they are just an extension of what we have. In theoretical terms, things are perfectly straightforward and simple—it is just a matter of tweaking the computer and sticking through a different rate. However, in terms of pure processing and getting information technology up to scratch, payroll money tends to be collected by employers and pension providers. They all need to get their systems in place, and there is a long lead-in time on that. HMRC, which will administer for us, will have a long lead-in time, too. It has quite a lot on its plate with staff cuts, bringing in digitisation and trying to transform many of its processes. We do not want it to be said again, “Oh, just change this on top of that.” It is really important to bring in the 2012 act in 2016 and get it properly bedded in. The rates and bands could be extended maybe two years later, for argument’s sake.

**The Convener:** Charlotte Barbour has just made quite an important point. Bringing in changes is taking four years, from 2012 to 2016.

**Charlotte Barbour:** That is taking a while.

**The Convener:** However, you think that things can be done in two years instead of the previous four-year timescale. That is helpful.

**Charlotte Barbour:** Quite a lot of the work towards having Scottish pay codes has been put in place. That will be expanded slightly. The issue is largely about system changes.

It is really important that the public are aware of what is coming in. I am not sure that everybody knows that they will have Scottish income tax as of 2016, let alone anything different.

**The Convener:** I think that the public will really get to know that only if it changes—then they will know about it.

Does the rest of the panel agree that two years would be long enough?

**Steve Couch:** My facial reaction showed what I think—we are in 2015 and we are looking at 2018. I am not sure how the months sit, but we might have longer than two years to look at the changes. I know that the legislation has not come through but, in preparing the public for what is coming through for the 2012 act changes, we know that more is coming down the track.

**The Convener:** So we will pass the legislation in spring 2016 and start to set rates in 2018.

**Steve Couch:** Yes. The second change will not have as much impact as the first change.

**The Convener:** That helps to give us some clarity about what industry and business would think.

Is it okay if we move on to the block grant adjustment? Mark McDonald indicated that he wants to deal with that.

09:45

**Mark McDonald (Aberdeen Donside) (SNP):** We have seen a microcosm of what might be yet to come with the recent application of new tax powers. I am thinking, in particular, of land and buildings transaction tax, which will replace stamp duty. The Scottish Government consulted early, with a view to announcing its proposed rates and bandings in the draft budget, but the autumn statement made changes to stamp duty that led to further complications around the block grant adjustment, which took some time to resolve. The Scottish Government subsequently announced revised rates.

Concerns have been expressed to the committee—by, for example, Professor David Heald—that the requirement on the Scottish Government to declare its hand early, if you like, in relation to taxation might open up the possibility of Treasury gaming around tax. What are your

views? Do you consider that to be a potential risk to the Scottish Government and to the tax system?

**Professor Muscatelli:** I am happy to start. I think that that is one of the areas that could be subject to gaming, which is why there has to be a very clear understanding of how such issues will be resolved between ministers on both sides.

When there is talk about a fiscal framework, economists put quite a lot of emphasis on independent assessment of the whole fiscal framework through the Office for Budget Responsibility at UK level, and the Scottish Fiscal Commission here. One way of avoiding conflict, which I think could happen—because, more often than not, Governments will take different interpretations—might be to find a role for the independent experts in which they give judgments that inform discussions between ministers. As was said earlier, at least stamp duty and landfill tax were completely devolved, so we are talking about first and second-round effects of that. With income tax and other forms of expenditure, including those that are not within departmental expenditure limits, there is a very different process; the danger is that there could be very different interpretations of what is going on, which I think could lead to some difficult discussions.

**Mark McDonald:** The point has been made that if, for example, the UK Government took a decision radically to increase the personal allowance, that would impact on the Scottish tax take but, on paper, the Scottish Government would not have any influence over that decision. Although the UK Exchequer would have at its disposal a full range of tax levers to offset that decision through other tax increases, that flexibility would not exist at Scotland level to the same degree. That gives rise to a question about the no-detriment principle.

A suggestion that the Law Society of Scotland made to the Finance Committee is that there should be some form of financial fair-play agreement that would prevent such scenarios. Is that something that you could conceive of? Would it be a good thing to introduce?

**Charlotte Barbour:** That sounds sensible.

**Professor Muscatelli:** That sounds sensible, but at issue would be the evidence that would be brought to bear in relation to such financial fair play. It could be a problem of interpretation. Again, I wonder whether in those circumstances there might be a role for the OBR and the Scottish Fiscal Commission to play in deciding on what sort of evidence base fair play might be discussed. Otherwise, it is inevitable that there will be some gaming.

**Mark McDonald:** Do other witnesses have anything to add to Professor Muscatelli's comments?

**Steve Couch:** I cannot discount the comments that Professor Heald made. Further work needs to be done on that. The suggestion is in line with the Smith recommendations relating to improved intergovernmental working.

**Duncan McNeil:** It is fair play to recognise that some sort of discussion is needed, and we all accept that it will be difficult.

However, to go back to the earlier point, it is surely better in any given constitutional situation—whether that is independence, full fiscal autonomy or whatever—to have difficult discussions and relationships rather than no discussions at all. The impact would still be the same, would it not? The scenario of a smaller country with a dominant economic partner making decisions on taxation would have an impact in any of the areas that have been mentioned.

**Professor Muscatelli:** One difference is that two independent countries, side by side, one big and the other small, would both have a full range of fiscal levers. In the situation that we are discussing, the balance is not equal. We need a framework for the discussions. At present, the Chancellor of the Exchequer is able to make his autumn statement and present a budget without too much reference to what is happening in Scotland. I am saying that we need a structure in which there is prior consultation, and we need a way in which to resolve differences of opinion. That would bring—or should bring—into play a very different relationship between the two Governments.

**Duncan McNeil:** Do you agree that difficult discussions are better than no discussions, as you have just described?

**Professor Muscatelli:** Absolutely—we can have difficult discussions, but we need a framework for trying to resolve matters if there is no agreement.

**The Convener:** That is helpful.

**Duncan McNeil:** I think that Charlotte Barbour wanted to come in too.

**Charlotte Barbour:** No, it is fine.

**The Convener:** That response is helpful with regard to laying out a potential framework in which discussions could take place. However, parliamentarians, whether at the House of Commons, the House of Lords or here in the Scottish Parliament, need to know what is going on in those discussions.

If tensions exist, no Government will give away their pre-negotiating position. However, do you

agree that, if the discussions are going to take place in the sort of structure that Professor Muscatelli described, they need to be as transparent as possible or the gaming element will be even stronger? Have you any idea how we can make them more transparent?

**Charlotte Barbour:** Transparency would partly involve a clear understanding of how the technicalities and the administrative side of tax interact. To come back to the example of corporation tax, people do not always completely appreciate the behavioural consequences that arise from one tax changing and affecting another. During my professional career, I have found that to be quite difficult. We gave an example earlier. If income tax rates were to change, one might consider running one's business through a company. We need a clear understanding of how pulling different levers might make people do things differently.

**The Convener:** You are, in effect, saying, "Yes—transparency is vital in the process."

**Charlotte Barbour:** Yes.

**The Convener:** Who wants to have a go at telling me how the block grant works, then? *[Laughter.]*

Until such time as we have real transparency around that mechanism and how it changes—

**Charlotte Barbour:** Perhaps I can come back in on that point, because it is very relevant. VAT ought to bring in quite a bit of money, but it is not obvious how VAT will be calculated as a standard number, never mind taking it on and looking at its effects through the economy and through the block grant adjustment.

I will not put my head above the parapet with regard to block grant adjustments—

**The Convener:** I do not think that anybody in the country would do that.

**Professor Muscatelli:** I will add one important point on why the UK might be different from other countries. The UK has had such a centralised system of setting tax revenues that there is a different psychology in the Treasury in dealing with such matters. That needs to be overcome, because we are now trying to put in place a structure that is much more akin to that of a federal country. The problem is how we do that and create more symmetry in the power structure and in the instruments of Government, and in political scrutiny. That will require quite a big psychological change in how the Treasury goes about preparing and consulting on a budget. That is one of the big issues—we need a big change of culture, if I can put it in that way.

**The Convener:** I have one last supplementary on that, and then we will go to Alex Johnstone. I know that Linda Fabiani wants to ask about VAT—

**Linda Fabiani:** Yes, and I have another wee question before that.

**The Convener:** We will come to that. Alex Johnstone can go next, followed by Linda Fabiani and then Stewart Maxwell, but first I have a question.

We have discussed the structures that are needed to make the process transparent and to make it work, and to give business certainty so that people know what is going on. How soon do those structures need to emerge to ensure that everything works? I ask the witnesses from PricewaterhouseCoopers to answer that if they can.

**Steve Couch:** I am not going to give you a calendar date, I am afraid. The ball is rolling on initial steps to inform business of what is going on.

There is work to be done with individual members of the public with regard to some of the proposed tax changes, most obviously in relation to place of residence. That has not started yet, so people do not know what is coming.

I am aware from talking to friends and to people in the street that there is still no great sense of the potential for income tax changes. There is a lot to do on the processes, specifically in relation to the points that the convener mentioned. We need more of a sense of purpose about where we want to get to and when—a project plan, if you like—rather than just thinking about what is expedient for a particular day.

**The Convener:** Thank you. Does anyone else want to pick up on that?

If no one else wants to respond, we can leave it at that: we need a project plan. That is fair enough.

**Professor Muscatelli:** Absolutely.

**Steve Couch:** I am sorry. I should add that it should be a public project plan.

**Alex Johnstone:** We got a clue yesterday in John Swinney's speech, when he told us that the fiscal adjustment for land and buildings transaction tax in Scotland was, after a two-year stand-off, dealt with by agreeing to split the difference between the two estimates. I take it that you agree that that is not a basis for progress.

**Steve Couch:** You might not feel comfortable about putting that out on a transparent basis. *[Laughter.]* I do not know.

**Alex Johnstone:** How do you see the strengths of the partners who will be negotiating on the

matter? I am talking about the strength of the framework that is required. Do you see the situation as being that any Scottish Government that has to negotiate with the Treasury will be starting from a position of disadvantage, and will therefore require an extremely strong framework within which to operate?

**Steve Couch:** I will comment on that only in very general terms. I would look at where similar arrangements have worked in the past internationally.

**Alex Johnstone:** Have you any examples?

**Steve Couch:** Czechoslovakia.

**The Convener:** That involved two different states.

**Steve Couch:** There were not two different states at the time, although there are now.

**The Convener:** You are referring to what those countries did before separation.

**Steve Couch:** There might be a learning opportunity there.

**The Convener:** What about Canada?

**Steve Couch:** I am not in a position to comment on Canada. I have not worked there.

**Professor Muscatelli:** We should learn from other states. It might be useful to look at Canada, although the situation there is a bit different, of course. Canada does its horizontal equalisation a bit differently: rather than having a block grant, it has a system that is based on a historical formula.

There is a potential issue with asymmetry of power in the UK, because of the resources that are available to both sides. On the point about culture, we cannot overnight change centuries of history in which the Treasury has been at the centre of UK fiscal decisions.

I would like to see whether there is some way of creating arbitration, which is why I brought into play the possibility of the OBR and the Scottish Fiscal Commission working together to adjudicate when there are very different perspectives. The question of how we embed that in legislation is another matter. It might become an administrative convention between the two Governments, which might at least resolve the potential for how we would adjust the block grant to trundle on for several years after every budget bill.

**The Convener:** We have an alphabet soup here, so it is important that the two Governments talk to each other and reach an agreement on what the framework looks like and which institutions will be involved, in order to give the process some strength.

Linda Fabiani has a supplementary and a question on VAT.

**Linda Fabiani:** Am I asking the supplementary, or both my questions?

**The Convener:** You can start with the supplementary and then go on to VAT.

**Linda Fabiani:** Okay. The supplementary is on a point that struck me when Professor Muscatelli used the F-word: federalism. We have heard constitutional academics and other witnesses describe federalism as power sharing. I would like an opinion on whether what is on offer in the draft clauses is, in fact, power sharing.

10:00

**Professor Muscatelli:** "Federalism" is a very difficult word to decode, because there are different fiscal arrangements in different federal countries.

I will return to the discussion that we have just had: given the interdependence that is suggested in the fiscal structure that has been proposed by Smith, there being no form of power sharing around such decisions will create real difficulties. We have never had to have that in the UK, because fiscal powers have been so centralised. If we do not find some element of power sharing, it will not amount to federalism. By definition, federalism is about distributing power. The aim here is to adapt a very centralised structure to do something a bit different.

**Charlotte Barbour:** It will take time.

**Professor Muscatelli:** Yes, it will take time, and it will be very difficult unless there is willingness on the part of the Treasury to share some of the power.

**Charlotte Barbour:** The emphasis has to be on sharing, because the taxes that are fully devolved are quite small taxes—you could not run a country on the strength of those finances—and some of them are not even designed as money raisers. Landfill tax, for example, is an environmental tax, rather than a money-raising tax, per se. Income tax requires joint responsibilities, so there must be power sharing there. One way or another, folk will have to pull together to make the system work.

**Linda Fabiani:** I was struck by something that Charlotte Barbour said right at the start about VAT—that the VAT calculation that will come, being an assignment of tax, will not reflect the Scottish economy. I would like you to explore that point a bit further.

**Charlotte Barbour:** So, the question is, where am I coming from on VAT?

**Linda Fabiani:** Yes.

**Charlotte Barbour:** That depends on how you measure VAT. Conceptually, VAT works by a bit of tax being added at every stage in the process. The assumption about the economy is that we get raw materials, make widgets and add value to them. They go to a distribution centre, and then to a shop. There are various stages in the process, and at each stage we add value. The idea behind a value-added tax is that we tax just the bit of value that is added at each stage in the process.

We have been talking about having a centralised Treasury. We have quite a centralised or integrated economy; there is no guarantee that everything that is done in Scotland will stay in Scotland. There was an interesting discussion at the Finance Committee about making biscuits in Glasgow. They are made here in Scotland, then go to a distribution centre in England from where they are distributed all round the place. There are questions about that example. Where do we measure the VAT? Is it when we make something here? Is it when we sell it there? How do we measure output tax and input tax to get the Scottish bit? That can be done, because we measure how much VAT is in the UK. Do not get me wrong—we can easily do it, but we do not do it just now. Borders are needed round that to measure the UK element going into or out of Europe. It would be necessary to do something like that administratively, but I do not know that traders would be keen on doing a lot more administration. I do not know how you would measure whether your outputs were here or there.

Certainly, a broad estimate of 8 per cent of the economy would be absolutely fine, and we would welcome that from an administrative point of view, but 8 per cent of the economy does not completely reflect the economic policies that are being promoted here in order to boost the economy. There is no such direct marry-up. The more accurate the measure, the more intricate the calculation.

**Linda Fabiani:** Let us go back to the principle of no detriment—or of whether you gain or lose, to put it in simple terms. We could end up with a Scottish Government doing loads to boost the economy, but unless the intergovernmental relations and power sharing are adequate, there might be no benefit from the measures that it takes.

**Charlotte Barbour:** It might be difficult to measure the benefit. It is not just about intergovernmental relations; traders collect all the VAT so they do a lot of the administration, although HMRC obviously does some as well.

We have such features to factor in. Of course we can measure the economy and how much goes in through VAT, but it is an intricate process. The no-detriment principle just adds to the

calculations; I do not know that we have the machinery to do those at the moment.

**The Convener:** We are still on VAT. Stewart Maxwell has a question, to be followed by Alex Johnstone.

**Stewart Maxwell:** My question is in exactly the same area because I picked up exactly the same point. I am struggling to understand—excuse me if it is just me—how there will be an agreement to measure the positive or negative impact of Scottish Government actions on the economy in relation to the take from VAT. There is clearly not a direct connection between the two things. For example, if the Scottish Government invests heavily in education or research, there will be an impact on business and that will have an impact on VAT take. There are lots of different complications to be considered. Can anybody on the panel see a straightforward way, or any other way, in which the impact—either positive or negative—could be calculated? How could that be done?

**Charlotte Barbour:** I certainly think that we can do it accurately. We can do what we want, but a burden will go with it.

**Stewart Maxwell:** On my point about the causal effect between one action and—

**Charlotte Barbour:** I think that that is difficult to measure.

**Professor Muscatelli:** I, too, think that that will be difficult to measure. That is one of the reasons why, when we see assignation being used around the world, it is not as a way of handing over tax powers that can then influence the tax base but more as a way of saying, “Here’s your share of the tax take and you can use it on spending decisions.”

To impose administrative requirements that call for value added to be tracked at every stage would be hugely burdensome. The only way to capture what Stewart Maxwell has just asked about—how, in the medium term, we can take into account the fact that the Scottish Government might have been successful in growing its economy—is to look at value added in different parts of the UK and link the take to that in some way, then recalculate the share of the first 10 percentage points and the 2.5 or 5 per cent reduced rate. If gross value added has grown by 10 per cent in Scotland and by 8 per cent in the rest of the UK during that period, we will have to adjust over time to take account of that. That is the only approximate way in which it could be done.

**Stewart Maxwell:** I have one further question on the PWC submission. Professor Muscatelli just made the point about assigning taxes and saying, in effect, “That’s your share.” One of the bullet



points in the conclusion of the PWC submission says:

“Assigning tax revenues (as an alternative to devolution) may seem an attractive compromise. Our concern is that this would increase both administrative complexity and exposure to tax volatility without any commensurate increase in the direct control of the Scottish Parliament over revenue-raising. Accountability would not be enhanced.”

Has PWC said that because it is about assigning a share rather than devolving control over the tax?

**Gwyneth Scholefield:** That is exactly right.

**Alex Johnstone:** I think that Professor Muscatelli has just talked about what I was going to ask. If we were to take the simplistic approach, it was suggested that we should have a percentage of the UK economy and allocate VAT according to that. Professor Muscatelli suggested that we could vary it according to economic indicators that we have for Scotland in many cases. Always looking for the simplest approach, I wonder whether a set percentage that was then varied according to relative economic performance would work.

**Charlotte Barbour:** I do not see why it should not.

**Professor Muscatelli:** I think that it could work. One of the interesting, longer-term issues that it would raise would be the purpose of the block grant. In the UK, it is a historical allocation. Other countries that make use of tax assignment—Germany is an example—have a different mechanism for horizontal equalisation. If, over time, there is divergence in the UK—let us suppose that the Scottish economy grows faster than that in other parts of the UK—the issue may be raised about how that should be taken into account in terms of burden sharing around horizontal equalisation. The administrative complexities of doing that in any other way, and estimating the value added in different parts of the UK, would be quite considerable.

**The Convener:** That is quite intriguing; I want to dig a wee bit deeper. Are any figures available that show what the VAT take is from the regions or the nations of the United Kingdom? Such figures probably do not exist.

**Professor Muscatelli:** The VAT take is estimated in “Government Expenditure and Revenue Scotland”. I do not know enough of the details about how that is constructed, but it is possible to get the figures.

**The Convener:** If we were to start with a percentage and make an adjustment afterwards, it would be pretty crucial for Scotland to know where the percentage level lay to begin with. We could start off with a position that was either incredibly advantageous or difficult. The first calculation

would be vital in ensuring that the amount of money coming into Scotland was maintained.

As far as I am concerned, the game is to ensure that Scotland gets the best out of the idea. If, after today, you consider that there is a particular methodology that might be helpful, please let us know.

**Bill Kidd (Glasgow Anniesland) (SNP):** This might sound a wee bit outré or there might be something in place—I do not know—but is there the potential for an independent body or a tax tsar to establish what the benefit has been to Scotland of an increase in taxation?

Let us say that Scotland was economically outperforming the rest of the UK, but Westminster was doing something that caused detriment to the taxation that was raised in Scotland. In that situation, we would not want an argument between the two Parliaments, with one of them saying, “This is the way we’re doing it and you’ll just have to put up with it.” Could someone arbitrate over that, or would we need something completely new?

**Steve Couch:** I cannot immediately think of any parallel to give you that is on all fours with what you are saying. It is a possible outcome of intergovernmental discussion, along with other potential outcomes.

**The Convener:** Anton Muscatelli has described a structure for that. For example, the Scottish Fiscal Commission could be an arbiter and there could be some way of working together. Are you asking for something like a court of final appeal?

**Bill Kidd:** No—not a court of final appeal, but something that would be on-going throughout the fiscal year. It would be unreasonable to wait until something went wrong before we started to address the issue. Basically, I was asking whether it seemed reasonable that there should be an on-going calculation and that someone would be able to say, “That has been a detriment, therefore it needs to be equalised or set correctly.” I do not know whether that is possible.

**Professor Muscatelli:** That would be a reasonable approach. As the convener said, I suggested something that builds on the fact that Scotland and the UK already have the Scottish Fiscal Commission and the OBR.

In a very different context—not on taxation, but on spending—Australia has the Commonwealth Grants Commission, which makes recommendations to the Parliament on the allocation of grants across the federal state in order to try to depoliticise the process. One could think of something similar whereby, if the UK Government and the Scottish Government could not agree, the OBR and the Scottish Fiscal

Commission could be brought together and could say, "In the absence of agreement, we suggest that this is an interpretation of what is happening." That is just a suggestion; there may be better mechanisms around.

**Bill Kidd:** Thank you very much.

**The Convener:** That is a very helpful suggestion. We will examine that a bit more.

10:15

**Stuart McMillan:** Paragraph 17 of the Smith commission report refers to the need to respond to

"the changing needs and aspirations of the people of Scotland within the United Kingdom. As a result, it may be appropriate to devolve further powers beyond those set out in the heads of agreement where doing so would aid the implementation of the consensus reached by the parties in this report."

Both Ms Barbour and Professor Muscatelli have used words such as "centralisation" in relation to the Treasury and have said that the powers that are to come are not income-generating powers. Obviously, the revenues from VAT will be assigned. Are there any taxation powers or other powers that should come to Scotland to address the point that is raised in paragraph 17 of the report?

**Charlotte Barbour:** Our original submission to the Smith commission focused on income tax, because that flowed from the changes that were already afoot. We said in our submission that we did not think that the general population were particularly aware that they were already getting the Scottish rate of income tax. Smith takes that process further. There would be a lot to be said for seeing how all that works before looking at further tax powers. I would have thought that you would have quite a lot of responsibilities with income tax.

There are the other taxes, too. It has been interesting to see that LBTT is already having an impact, even though we have not got it yet. We should perhaps work with all those taxes before we look at other taxes to devolve. The devolution of other taxes might be for later and we might look across the UK at how powers would be devolved, for example, to Wales and to Northern Ireland. I know that this sounds perverse, but you want to have some kind of overall control over how you devolve powers, do you not? It seems that corporation tax might be going one way and income tax might be going another way. It seems a bit disjointed.

**Stuart McMillan:** Do you mean that the present system seems a bit disjointed?

**Charlotte Barbour:** I mean the fact that corporation tax is being devolved to Northern Ireland, some income tax is being devolved to

Scotland, and Wales is getting some powers. As I say, it seems perverse to say that you want there to be some kind of oversight of how powers are handed out. It may be that if all regions or nations—I am about to put my foot in it, am I not? If everybody got income tax powers, for example, that would make it much easier to negotiate how power is properly decentralised.

**Professor Muscatelli:** I set out a lot of this in my submission to the Finance Committee back in November. In my view, given that there now seems to be a strong appetite in Scotland for greater fiscal autonomy, the cleanest solution would have been to have a package that would have involved not only complete income tax devolution, including the personal allowance, but national insurance contributions, which would have perhaps allowed some flexibility around employers' national insurance contributions to try to affect employment, since that issue seems to be of concern to Scotland.

I also suggested that, in the light of European rules, areas such as VAT could be subject to assignation and that some flexibility could be introduced around corporate taxation to avoid administrative complexity and to link in more with employment decisions, when companies decide where to locate in the UK. The Holtham commission in Wales suggested that there could be such flexibility. Some of those options to go further than the current set of powers that is proposed by Smith could have been explored.

**The Convener:** We are back where we started.

**Duncan McNeil:** Reference has been made to tipping the balance and the need, when devolving more powers, to balance full fiscal autonomy with the impact on the Barnett formula. Does anyone want to comment on that? Serious concerns have been expressed about full fiscal autonomy and the end of the Barnett formula, which would not exactly be a happy place to be. Professor Muscatelli was arguing for full fiscal autonomy.

**Professor Muscatelli:** I was arguing for a more rational package to avoid having to split taxes in half, and in my submission in November, I suggested how that might be achieved. In fact, if you recall, I said at the beginning of that submission that there is no correct answer to this; it is all about the political economy and the will of the Scottish people. If Scotland wants more fiscal autonomy, this is the logical way to progress; you would start with certain taxes and have certain taxes last. I suggested that you could even do some things with corporation tax.

What you do with the block grant absolutely depends on how much fiscal autonomy you have. If you have almost complete fiscal autonomy, by definition the only question with the block grant is

whether you want a block grant that equalises horizontally across the UK nations to provide some insurance mechanism.

The Barnett formula is a historical construction that exists because of the history of fiscal allocations in the UK. If you had 100 per cent fiscal autonomy, you would not have the block grant as it is currently constituted; instead, you might have something different that equalised to share burdens or insurance. That is what they have in Germany and Canada. In any case, all of this would depend absolutely on how much fiscal autonomy the Scottish Parliament had and how much taxation it raised as a proportion of its total spend.

**Duncan McNeil:** Looking at the German example and, indeed, other examples, what comes first, then—federalism or fiscal autonomy? What if we had a structure in which we did not pay taxes, national insurance or whatever into the centre, but we still had a safety net in the form of Barnett?

**Professor Muscatelli:** Our discussion illustrates that if there is more fiscal autonomy, even in the form envisaged by Smith, you need more decentralised power structures, because otherwise there is likely to be more political tension across the UK.

The two things go hand in hand. There are federal states across the globe that have very different visions of how much equity and accountability they have. I gave some examples in my previous submissions; for example, Germany is very different from Canada, because they have different concepts of where they want to sit on the spectrum between fiscal autonomy and equity. The point is that if you decentralised fiscal powers—this is one model that we are discussing; you could go further—you would need to decentralise administrative and political power, too, because if you did not, you could end up with conflict between the two Governments and Parliaments. That is not where we would want to be; instead, we want some form of determining solutions to where conflict might arise, which brings us back to our earlier discussions.

**The Convener:** We are moving away a bit from what we are supposed to be talking about, but I understand why that has happened, and the discussion has been interesting. However, let us come back to our main purpose. I will bring in Steve Couch and then come to Alison Johnstone.

**Steve Couch:** I was just going to comment on the tax question, and I hope that my remarks will also play to Mr McNeil's question. We should not lose sight of the fact that there is pressure for more uniformity of tax rates; for example, there have been cries for uniform corporation tax rates

across the European Union. When you look at what happens between the rest of the UK and Scotland, you need to consider that context, too.

**The Convener:** Fair point.

**Alison Johnstone (Lothian) (Green):** Obviously, the Smith commission was all about compromise. Compromise was required to enable any sort of an agreement to happen, given that the visions of the parties going into those discussions were markedly different. However, people such as Richard Murphy have said that Scotland's tax solution is very challenging and is not all that it could or should be. The witnesses have expressed concern about putting the devolved tax systems in place and running these two domestic and related systems side by side. We also seem to have a cultural lag. Do you think that we can address that? Is it possible to get these systems up and running as and when we need to, given that a lot of the political discussion is still going on?

**Charlotte Barbour:** I do not think that there is any reason why it cannot be made to work. Stamp duty land tax is to be switched off; LBTT is coming in; and folk are learning as the process goes on—but, hey, the tax is coming on 1 April. We will have it, and it will work one way or another.

Likewise, the Scottish rate of income tax is being introduced in 2016—

**Linda Fabiani:** Do you want to define “one way or another”?

**Charlotte Barbour:** No. [Laughter.]

I think that if you want to do something, you can do it, but you need to be aware of the costs and the administrative burdens. The reality is that a lot of taxes are not collected by the state; that job falls to employers or to the self-employed through their self-assessed taxes. In other words, the citizens are doing it. You need to be aware of the impact of these moves, which is, I think, part of what we been trying to talk about this morning, and how they will be received. After all, it is just a fact of life that not everybody is as excited about tax as others are.

I think that we need to go cannily with some aspects of tax and have an appreciation of some of the burden that business might come under. Business does not always look at where its tax comes from, and in recent times, it has had quite a lot of system changes such as auto-enrolment and RTI. We need to recognise what the new taxes will do for them.

**Alison Johnstone:** Do you think that enough attention has been given to ensuring that businesses have the resources and information that they need?

**Gwyneth Scholefield:** With regard to the Scotland Act 2012, I think that the awareness level is starting to rise, but it is probably not where we would all like it to be. Some of that plays into the fact that we are not all tax geeks. However, I think that people are on a journey and are moving in the right direction.

That brings me back to my earlier point that the right thing to do is probably to embed the 2012 act and then take people on the next journey post Smith when it comes to income tax. People seem to have learned lessons and are taking things in bite-sized chunks. As Charlotte Barbour said, businesses have experienced a lot of system change, and as a result of the 2012 act, the systems will be embedded to allow the changes for the further devolved powers to be made. I think that that is possible.

**Alison Johnstone:** Thank you.

**The Convener:** Duncan McNeil has a question about parliamentary issues.

**Duncan McNeil:** Following on from our consideration of the cultural issue and the change that will be necessary to open up the process, I note that the Smith commission has been criticised on the basis of politicians making decisions behind closed doors. We are now in a phase of intergovernmental relations, with Government officials again discussing matters in closed rooms, and I am starting to get nervous about the roles in that process for parliamentarians, never mind getting communities involved and raising awareness at that level.

I realise that this is a bit off to the side of what we have been discussing this morning but, whatever happens, as Charlotte Barbour said, things are changing and there will be different challenges. As for the role of the Parliament and the challenges that it will face, the fact is that we have not changed the Parliament's procedures and responsibilities radically in the past 15 years since it was set up. However, there will be greater responsibilities on it. I do not know whether the witnesses have any comments on that. Witnesses in other evidence sessions have commented on the importance of open and transparent dealings and accountability, but I wonder whether the witnesses recognise the challenges that we as a Parliament face in keeping pace with these changes and in ensuring that we have openness and transparency in Government.

**Linda Fabiani:** That is a good one.

**Professor Muscatelli:** I am not an expert on parliamentary procedure, so you will probably need to consult a constitutional lawyer, but I certainly agree with what Mr McNeil said. If you start having intergovernmental discussions around budget bills well in advance, the Finance

Committee or the Treasury Select Committee will need to adapt the way it scrutinises these things; otherwise, you will not have proper parliamentary scrutiny. At the moment, the Treasury Select Committee scrutinises UK budget legislation and pays no heed to any interdependencies. Again, it is all about changing the culture, but you would expect the Finance Committee here and the Treasury Select Committee to find some way of co-operating on parliamentary scrutiny.

10:30

**Alex Johnstone:** I will take a step back from the detail that we have been looking at and comment on one or two things that have been said. There is obviously ambition for Scotland to have more power, but history is beginning to build up and what it shows us about such ambition is that although the power might be devolved, that does not mean that it is going to be used. For example, in the 15 years that we have had the power to vary income tax, it has not been varied.

More recently, we have watched John Swinney go through the process of trying to set the new land and buildings transaction tax, and his primary driver has been to minimise the fiscal variation. He wants it to be revenue neutral; in fact, he talks about that all the time. Looking at the proposed powers, how do you feel they will actually deliver for Scotland? Are we going to see an appetite for divergence, or are the pressures for convergence going to cause future Scottish Governments with a large basket of powers to spend their time trying to make sure that things are no different north and south of the border?

**The Convener:** You are not politicians but you can still have a go at that.

**Charlotte Barbour:** Steve, do you want me to go first or do you want to start?

**Steve Couch:** Ladies first.

**Charlotte Barbour:** Rather than commenting directly on the question, I will come at it from a slightly different angle and say that a number of points perhaps need to be addressed on a wider canvas in relation to public awareness. Harking back to what I have already said, I am not sure that people are very conversant with what powers we already have and whether they have been used. I do not know how we make tax more exciting to non-tax practitioners but that is perhaps what we need to do.

**Alex Johnstone:** Tax becomes exciting to taxpayers when you start increasing it.

**Charlotte Barbour:** Well, yes, and perhaps that is part of what needs to be looked at. How do we make tax more relevant to people? It is your

accountability mechanism and there needs to be greater awareness of it.

The other thing that we have noticed with tax over the years is that—to use a colloquialism—people want to pluck the goose with the least amount of hissing. No one really likes to tell people how much tax they will be paying. Perhaps what you are telling your electorate or your population about your taxes needs to be thought through.

**The Convener:** I see that you are going to try to excite us now, Steve.

**Steve Couch:** I will go with the no-politician line, but I think that you need to look at the powers—and how you exercise them—separately and find out why those powers have not been exercised or why Mr Swinney is currently looking for fiscal neutrality.

There is an element of public education in taxation. For example, PricewaterhouseCoopers has been running citizens' juries in which we bring about 20 members of the public together in a jury and inform them about some of the background, the detail of some of the possible tax changes or some of the discussions around tax. Then we look at the decisions that come through and at what people say.

As we mentioned in our pre-Smith commission submission, the broad conclusion from that experience is that people get engaged in the tax process. We do not pick random people off the street and say, "You must come and join our jury," but the people whom we pick become more engaged. They make different decisions based on that increased understanding and feel more involved in what is going on.

We do not need to make everyone a tax expert, but if we involve people more, we can have a stronger debate and, in our case, a better basis on which to advise Government and, in your case, a better basis to act on what comes out of citizens' juries, other public forums and other means of understanding public representations. The strength of that approach is that the Government can make decisions that are important to people and feel as though its decisions have been informed in a more sophisticated way than through simple polling.

**Alex Johnstone:** You appear to be trying to interpret my question politically. I will try to simplify it and ask the question in a slightly different way that should require only a simple answer.

**Steve Couch:** Please do.

**Alex Johnstone:** Nothing that we have done so far has provided a system that generates the momentum that overcomes the gravity towards convergence. Will the new package achieve a

level of momentum that will move us from a position of instinctive convergence to one in which divergence is possible?

**Steve Couch:** I would say that it is more likely to do that than what has come before, but I could not go further than that.

**Professor Muscatelli:** I agree. One argument that has a lot of currency is that the existing powers have not been used because they are limited. There is also the potential interface. In essence, the Scotland Act 2012 gives a flat tax that is superimposed on the existing UK system, and there is a fear that that will create the wrong sorts of trade-offs. By definition, giving more levers will allow political parties to put more acceptable packages to the electorate.

I agree with Steve Couch that there is a psychology of taxation issue that needs to be overcome. It is interesting how much debate there is in the current political situation on what the priorities should be on different public goods, such as health and education. I wonder whether we have seen the end of the era of people focusing solely on taxation as a big issue and whether we might be beginning to see some change so that people are willing to say, "Actually, I would like more public goods, thank you very much, and I am prepared to pay for them, because I recognise the economic reality of that." We might be having political debates like that quite soon.

I always smile when the Institute for Fiscal Studies produces its study of what actually happens to taxation post UK elections, because the estimate is that on average tax goes up by, I think, £5 billion more than what was promised before the election. At the margin, there are attempts to do that sort of thing, but there is a psychology issue that has to be overcome and the things that Steve Couch has talked about are very interesting.

**Linda Fabiani:** Anton Muscatelli said that, after every election, tax goes up, but the fact is that income tax is very different. Most taxation is indirect taxation. What level of financial lever is income tax?

**Charlotte Barbour:** A significant one.

**Professor Muscatelli:** It is one of the substantial levers. One of the reasons why taxation in the UK has gone up is because the 40p tax threshold has not kept pace with inflation. Often, that is the way it is done instead of a party putting it in its manifesto that it will put 2p on the range of income tax to pay for certain things. The discourse is often a bit more muted than that. For instance, income tax burdens in the UK have risen slightly over this Parliament, largely through the way in which the tax bands and thresholds are used.

**The Convener:** We have reached the natural conclusion of the discussion. I wanted to ensure that, today, we flagged up where the challenges lie, and I think that we can put a tick next to that, because you have successfully achieved that aim. We now know where we need to go in further discussions.

I thank all of you for coming along and exciting us about tax. I have become more fascinated in the area as I have begun to dig into it, and I am grateful to our witnesses for their helpful contributions.

10:38

*Meeting continued in private until 10:56.*

Members who would like a printed copy of the *Official Report* to be forwarded to them should give notice to SPICe.

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e-format first available  
ISBN 978-1-78534-872-3

Revised e-format available  
ISBN 978-1-78534-890-7