



The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

FINANCE COMMITTEE

Wednesday 22 April 2015

Wednesday 22 April 2015

CONTENTS

	Col.
DECISION ON TAKING BUSINESS IN PRIVATE	1
LOCAL GOVERNMENT FINANCE (UNOCCUPIED PROPERTIES ETC) (SCOTLAND) BILL: FINANCIAL MEMORANDUM (POST-LEGISLATIVE SCRUTINY)	2
FISCAL FRAMEWORK	17

FINANCE COMMITTEE
12th Meeting 2015, Session 4

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*John Mason (Glasgow Shettleston) (SNP)

COMMITTEE MEMBERS

Richard Baker (North East Scotland) (Lab)

Gavin Brown (Lothian) (Con)

*Malcolm Chisholm (Edinburgh Northern and Leith) (Lab)

*Mark McDonald (Aberdeen Donside) (SNP)

*Jean Urquhart (Highlands and Islands) (Ind)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Marco Biagi (Minister for Local Government and Community Empowerment)

Margaret Burgess (Minister for Housing and Welfare)

Jim Cuthbert (Jimmy Reid Foundation)

Stuart Law (Scottish Government)

Douglas McLaren (Scottish Government)

John McLaren (Fiscal Affairs Scotland)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The Mary Fairfax Somerville Room (CR2)

Scottish Parliament

Finance Committee

Wednesday 22 April 2015

[The Convener opened the meeting at 09:30]

Decision on Taking Business in Private

The Convener (Kenneth Gibson): Good morning and welcome to the 12th meeting in 2015 of the Finance Committee of the Scottish Parliament. I remind everyone present to turn off mobile phones and other electronic devices. We have received apologies from Richard Baker and Gavin Brown.

The first item of business is to decide whether to take items 4 and 5 in private. Do members agree?

Members indicated agreement.

Local Government Finance (Unoccupied Properties etc) (Scotland) Bill: Financial Memorandum (Post-legislative Scrutiny)

09:30

The Convener: The second item of business is evidence from the Scottish Government as part of our post-legislative scrutiny of the financial memorandum to the Local Government Finance (Unoccupied Properties etc) (Scotland) Bill. I welcome the Minister for Local Government and Community Empowerment and the Minister for Housing and Welfare. The ministers are joined by their officials, Stuart Law and Douglas McLaren. Members have copies of all the written submissions that have been received, along with a Scottish Parliament information centre briefing.

Before committee members ask questions, I invite both ministers to make brief opening statements. Who would like to go first? Is it ladies first?

The Minister for Housing and Welfare (Margaret Burgess): I will go first, convener. Thank you for allowing me the opportunity to give evidence to the committee today.

The council tax increase for long-term empty homes was introduced as an additional tool for councils to use to encourage owners to bring homes back into use. Councils have significant flexibility in how they can apply the increase, and 16 councils are now applying that power in 2015-16. It is too soon to measure the full effect of implementation because 2014-15 was the first year in which a significant number of councils applied the increase, having used the previous year to prepare for it.

The legislative change is one of a number of measures that the Scottish Government is taking to encourage owners to bring homes back into use. We continue to fund the Scottish empty homes partnership, which includes part-funding a number of empty homes officers who work directly with home owners. We also provide capital funding programmes. Collectively, the measures are having a positive effect in Scotland's communities: it is reported that 278 homes were brought back into use in 2013-14, and we expect more than 500 to be brought back into use in 2014-15.

Some owners have reported that the council tax increase is what encouraged them to take action. We expect that by the end of the next three-year period we will have reached the point at which

1,200 homes will be being brought back into use each year. That is a significant number, as more than 16,500 homes are empty for one year or more.

The Minister for Local Government and Community Empowerment (Marco Biagi): I, too, thank you for giving me the opportunity to come here. I hope that it is as enjoyable as my last appearance before the committee.

Our non-domestic rates regime must support businesses to flourish, and it must raise revenue to help to deliver the essential local services on which businesses depend. As part of that, the rates relief—which is worth about £618 million in total this year—must be targeted to provide the right incentives for growth. The Local Government Finance (Unoccupied Properties etc) (Scotland) Act 2012 enabled ministers to vary more widely the relief that is available for empty properties in order to incentivise their return to use.

The changes that we subsequently made by regulations were, as notified at the bill's introduction, to reduce relief for certain empty properties from 50 per cent to 10 per cent following the initial three-month rates-free period. The financial memorandum estimated that that would save about £18 million. However, the actual drop from the previous year that was recorded in the cost of empty property relief for the first year of reform, 2013-14, was £22.6 million. Other factors bear on the year-to-year cost of that relief, but that figure seems to be in reasonable agreement with the original estimate. The reform did not apply to industrial and listed properties, and the cost of empty property relief in 2013-14 was still £146 million—which is a considerable subsidy to support ratepayers.

Members will be aware that we responded to feedback from stakeholders and, in the same year, introduced the fresh start and new start reliefs, which relate to long-term empty properties and to new build, respectively.

During the passage of the bill, Derek Mackay committed to reviewing the effect of the changes once they started to bed in: I confirm that the Scottish Government will undertake that exercise this year.

I welcome the committee's initiative to undertake post-legislative scrutiny, and I am grateful for the chance to contribute and take questions.

The Convener: Thank you very much, minister. Those statements were helpful, as was the documentation that has been provided.

We are doing this because when we considered the financial memorandum, the various stakeholders gave us different opinions as to what

the impact would be, so it is time to see how the legislation has worked. This is the first post-legislative scrutiny exercise that we have done; we might do more in the future.

I will open up with some questions and will, in due course, allow other committee members to come in. Either minister can answer—it is up to you who answers—but I will put the first question to Margaret Burgess first. You said that it is too soon to measure the impact of the legislation, given how long it has been in existence, but the SPICe briefing that we received says:

“in relation to non-domestic rates, there are no systems in place aimed at monitoring the impact of the legislative changes.”

How can we measure the impact if there are no monitoring systems in place?

Margaret Burgess: The council tax monitoring on empty homes was changed to take into account the number of houses that are empty and the number of local authorities that are reclassifying properties between long-term empty homes and second homes. Some of the empty homes officers are doing that, so that information and the difference between the two is now recorded and is much more accurate.

Also, the local authorities report on whether they are applying the additional council tax on the long-term empty homes. That allows us to monitor that and how much local authorities collect from doing it.

The Convener: I think that about nine local authorities are implementing the increase in full.

Margaret Burgess: Nine local authorities are implementing the full increase, three are doing a staged increase and another one will do it halfway through the year. That information is all recorded and can be monitored, so the legislation is being monitored.

The Convener: Right. Is the Scottish Government encouraging local authorities to impose the full increase or is it allowing them to do their own thing?

Margaret Burgess: It is very much up to the local authorities; there is a lot of flexibility in the legislation. It is down to whether local authorities feel that they should implement the increase in their areas. Argyll and Bute Council was very supportive of the legislation from the outset because it has so many empty homes. Its priority was to bring them back into use, not to get additional resources. Through the empty homes partnerships, a number of other local authorities are also working on that. However, there are some areas where it would not be appropriate for the local authority to apply the legislation—for

example, areas in which there are hard-to-let properties.

The Convener: Thank you.

Do you want to add anything, Marco?

Marco Biagi: I will comment on NDR and monitoring. A lot of data are collected: we have the valuation rolls and council returns. The trend line for the number of unoccupied properties took a noticeable dip in the first year of effect. We also have the figures for relief, which I have already related.

When we try to monitor and separate out the effects of the legislation, the important thing to consider is that there are a lot of reliefs at play. There is £618 million-worth of reliefs and, in some cases, a property might be brought back into use, but then trigger a small business bonus or a charity relief, so it can be hard to disentangle exactly what the change arises from.

However, the trend is pretty firm and obvious. It is an evident one-year change, so we believe that it fits with the estimates in the financial memorandum, and that what we predicted is happening.

The Convener: The Finance Committee sent a number of questions to local authorities about what the legislation tries to achieve. I am looking at the responses from North Ayrshire Council because Margaret Burgess and I are MSPs for that area, but we also have responses from other councils. We asked to what extent changes could be attributed to the empty property relief reforms as distinct from wider economic factors. North Ayrshire Council said:

"There is no evidence to suggest that the change in the empty charge from 50% to 90% has encouraged owners to sell or lease their empty commercial properties."

Aberdeenshire Council also said that there is no evidence, as did Angus Council. Most of the local authorities that we contacted said that there is no evidence.

We asked another, similar question:

"Is there any evidence to suggest that the reforms have had an impact on speculative development and/or regeneration activity?"

Again, North Ayrshire Council said:

"There is no evidence to suggest that the reforms have had an impact on speculative development and/or regeneration activity."

Angus Council and Aberdeenshire Council also said that there is no such evidence.

I realise that the legislation has not been in force for long, but is the Scottish Government concerned that the legislation has not made much impact? It seems to be a general restoration of

economic fortunes that has reduced the number of empty properties.

Marco Biagi: The objective of the bill was partly to target relief better and partly to deal with the issue of empty properties. It may well be that individual local authorities, which are looking at a small piece of the overall cake, are not seeing the overall effect. The long-term trend line—I have a graph that I would be happy to provide to the committee—shows a significant dip in the percentage of properties on the valuation roll that are unoccupied. That is collected by looking at data from across Scotland.

One can question how much any one local authority is dealing with the whole range of businesses and considerations that are involved. The legislation was not a great sweeping measure that would wipe out empty property relief and fill every property overnight; rather, it was an incremental step to target more accurately the reliefs that we provide. As a result, we have lower contributions in empty property relief and there are signs across the country that property is moving back into use.

In response to question 3, North Ayrshire Council highlighted the fact that it had 26 commercial properties brought back into use. It might not be able to give the exact reason for that based on its own analytical resources and contacts, but when the picture is replicated across the country, we see incremental but positive change.

The Convener: Yes—but the question is whether the change is due to the legislation or just to the pick-up in the economy. That is what we are trying to pin down.

Another issue that SPICe has brought to our attention is that there was no real baseline for the number of vacancy rates in the first place, so it is hard to see where there has been an impact.

I want to let my colleagues come in, and there are time constraints, but I will ask another question so that we can move on a wee bit. Highland Council referred to an increase in the number of pop-up shops, which it felt may be in response to changes in empty property relief. North Ayrshire Council—again—told us that the ratepayer for one property says that it

"is being used for storage purposes for six weeks then claims a further 3 month 100% period in accordance with Legislation."

Are you concerned that people will develop ways around the legislation and if so, what proposals does the Scottish Government have to counter that?

Marco Biagi: Whenever the Government tries to raise revenue, people will find ways to get round

the system or to make it more advantageous for them. Let us not rule out pop-up shops by suggesting that they are a terrible thing; the protections for three-month leases were introduced with fine intentions. If there are expansions of that practice and the provision is being misused, we would consider that as part of our own post-legislative scrutiny. Any evidence that the committee finds in its process would help inform our work. It is something that we would keep under review.

The Convener: Finally, one or two local authorities have concerns about additional costs. West Dunbartonshire Council—I have to say that that council, more than other local authorities, has often in evidence expressed concerns about additional costs on a wide range of legislation—has said that it has additional costs of approximately £45,000 year on year. That council does not suggest that there has been much of a positive impact, but that its cost base has increased. What do you say to such local authorities? Will your review look at the impact of the legislation on local authorities in terms of additional costs?

09:45

Marco Biagi: There is a varied picture. Argyll and Bute Council quantified its costs as being lower than those in the financial memorandum, so there is a broad range of views out there. I do not know exactly what West Dunbartonshire Council has done that has caused its costs to go up while other authorities have done things that have caused costs to go down. That would be worthy of review. There are local authorities that have managed the legislation efficiently, so local authorities should be looking at each other to find good practice in collection.

The Convener: Thank you for that.

John Mason (Glasgow Shettleston) (SNP): I will follow on from questions that we have had already. The point has been made that in relation to council tax only one authority—Western Isles Council—brought in the full powers immediately. Was that disappointing or was that to be expected—and does it matter?

Margaret Burgess: That was not disappointing from the Government's point of view. The legislation was something new that local authorities had been looking for. The Government never meant it to be prescriptive for councils. The legislation is about encouraging local authorities to consider how empty homes could be brought back into use and it gave local authorities that want to use it another tool to do that. There is now much greater focus on bringing empty homes back into use.

John Mason: I do not know whether I would have anticipated their doing so, but some local authorities are taking a bit of time to think about it before introducing the measure and some are introducing it gradually, which seems to make sense. When would be a good time to look back? My ultimate question is this: are we looking at this too soon? Should we wait for five years to look back and get a better picture, or would that be too late because we might want to tweak things before then?

Margaret Burgess: The policy should be looked at in stages; it is useful to look now to see what local authorities are doing, and to see the benefits and projections. However, it is certainly too early to see real indications of the legislation's impact, given that only 16 local authorities are currently applying it. Last year 14 were doing so and the year before that only one was. We have to look over a longer period to see the impact. For councils, the policy is not about raising revenue but about bringing back into use homes for people who need them.

John Mason: I presume that that is a bigger problem in some local authorities than in others. You are not anticipating that all 32 authorities will act, are you?

Margaret Burgess: Not necessarily all 32 authorities will act. More and more councils are using the tool. As they and the empty homes partnerships work together and good practice is shared, a local authority that had previously thought that it would not want to implement the legislation, or that doing so would not necessarily be of benefit, may see benefit from what is happening in other local authority areas. It is about sharing what is happening and getting the message out there; I think that that is happening through the empty homes partnerships.

John Mason: That is helpful. Thank you. Some of us feel that it is quite early to be looking at whether we can get a good view of implementation. You said that there was a dip in the trend, but other things are happening that might explain that—for example, the economy might be growing a little bit. When can we get a really good view of what is happening?

Marco Biagi: There is the old saying about the French revolution—about how we are still trying to work out now what its consequences are. You can take any point in the future and look back from it with ever greater information. At the moment we have just a mid-year estimate for 2014-15, whereas we have the full figures for 2013-14. When we have at least two proper data points, we will better understand trends and we can work with that rather than just with estimates. That is why we will do our post-legislative scrutiny on NDR this year when data are available. However, we could

wait two more years and get two more data points and continue to analyse from an even more informed position. It is really about when to draw the line and say, "This is the appropriate time."

I think that now is a little on the early side, but it is certainly valuable to canvass opinion and to gather and look at data. We certainly welcome post-legislative scrutiny in general.

John Mason: This committee and others will do post-legislative scrutiny, although one of the challenges is about when the right time is to do it.

The convener mentioned West Dunbartonshire Council. I, too, was interested by its submission. Although it does not go into huge detail, it seems that the council is deliberately holding on to some empty properties because it wants to put a few together for redevelopment. Has it been caught unexpectedly by the legislation because it is sitting with empty properties for a good reason, or is that just one of the things that we would have expected to happen?

Marco Biagi: Is that an NDR measure? I am not familiar with West Dunbartonshire Council's submission.

John Mason: Yes, I think that it is. The council says that it has, for example, a medical centre that is difficult for it to let as anything else, so it is taking time over that. Obviously, there is pressure on the council to immediately pay rates.

Marco Biagi: West Dunbartonshire has particular issues with regard to occupancy. It is noted for having a relatively large proportion of properties that are hard to let in both the non-domestic and domestic sectors. That is clearly an issue for the council. However, the purpose of the legislation is to incentivise people and to get them thinking about alternative uses so that we get as much property as possible back on the market. We have to ask where councils go too far and what is the right level of pressure and use of the stick. I do not know the local circumstances in West Dunbartonshire—there are 32 sets of local circumstances—so I cannot comment on the exact issues that face the council. However, the aim is to come up with alternative uses and to bring buildings back into use. I hope that there are ways to do that.

John Mason: That is fair enough. Can you assure us that you will listen to local authorities and that if anything is being caught that we had not intended to catch, you would be open to looking at that?

Marco Biagi: Yes, we would be open to doing that in our review and in general dialogue with local authorities. I have met West Dunbartonshire Council on other general and introductory issues, and I have corresponded with it on a range of

financial issues, but it has not raised the point that John Mason mentioned, so it might not be at the top of the council's list of concerns.

Mark McDonald (Aberdeen Donside) (SNP):

The convener mentioned the lack of evidence on the impact on speculative development of the changes to non-domestic rates. I seem to remember that one concern that was raised during the evidence taking on the bill was that it would act as a deterrent to speculative development. Is it a bit early for us to say categorically whether that has been the case, or is there evidence from the year and a bit for which you have information on whether speculative developments that were likely to take place have done so?

Marco Biagi: That information is collected more at local authority level. We have been in dialogue with local authorities, and the fresh start and new start schemes have been put in place to try to deal with the innovative, risk-taking and entrepreneurial side of property development to allow new development to continue. I represent Edinburgh Central, and I remember that, when the bill was being discussed, business centres had issues because they had a lot of people coming in and out. The Government listened to that and, by putting those two measures in place, we have addressed the issue. Our approach of using regulations rather than acting straight away means that we have been able to adapt the measures in the light of evidence that has come forward.

On the broad picture, speculative development tends to have very long horizons for planning and substantial numbers of considerations tend to be at play. I would definitely say that it is too early to tell the overall impact, but we have been happy to take steps to try to address issues and to forestall that happening.

Mark McDonald: During the evidence taking and debate on the proposed legislation, I took the view that we could not see the measures in themselves as some sort of magic bullet, and that there would be interaction with other circumstances, such as the wider economic situation. Is it possible to completely disaggregate the impact of the measures from other factors, or is it the case that the measures are complementary to other factors in bringing properties back into use more quickly?

Marco Biagi: There is a multiplicity of factors pulling mostly in the same direction now. If this had happened four years ago, the committee might have been faced with a flat situation whereby the removal of relief would be pushing towards filling the properties and the economic circumstances would be pushing in the opposite direction, so the committee might have ended up looking at the situation and saying, "Well, nothing's happening." We now broadly have two factors that

are pushing in the same direction, so it is always going to be hard through a simple look at the numbers to see exactly what that difference is. There has been a £22.6 million drop in the relief, whereas our original estimate was £18 million. When we factor in some of the things that we can assess quantitatively in terms of other reliefs and changes in poundages, there is still a fairly large chunk that is in the vicinity of the £18 million that was the objective.

We could perform interviews with every owner of property across the country and go into all kinds of research to a possibly disproportionate scale to try to tease out the mental processes in the decision making; if we took everybody at their word and they did not regard the information as commercially sensitive or confidential, we might have something. Alternatively, we can look at the numbers and say that there has been a drop and that, on the principle that the fairly obvious factor that has come into play in that period is the removal of the empty property relief, that is by far the likeliest suspect. Anybody who wants to try to prove otherwise really has a case to make.

Mark McDonald: Turning to the issue of long-term empty dwellings, there is a table in annex C of a letter to the convener from Mr Swinney that shows the number of empty dwellings per local authority. Some local authorities that have quite high levels of empty dwellings do not appear to have taken any action at this stage to implement the changes to the reliefs that the Government has put in place. Has there been any indication as to why Glasgow City Council, for example, has not taken those steps although, according to the table in annex C, it has in excess of 2,000 long-term empty dwellings?

Margaret Burgess: The Government has not looked at that at this point. It would depend on, in some instances, whether such properties were spread around the city. If they were in one area, for example, the council could exempt that particular area from the additional charge. However, if they are spread around the city and among hard-to-let areas and areas of regeneration where people are being moved from one property to another, it may not be appropriate to apply the charge.

We are now working in partnership with Glasgow City Council through the empty homes process to look at what can be done. Local authorities can use discretion and ask, "Is this appropriate just now at this place?" If there are pockets of empty properties throughout and they are hard-to-let properties, how does the council exempt areas where there are clearly issues that mean that it might not be appropriate to apply the charge?

However, if the committee wishes, we could follow up on that issue as the legislation progresses if some authorities are not picking it up at all and look at the reasons why local authorities are doing that. There could be a variety of reasons, though, and it is about flexibility.

Malcolm Chisholm (Edinburgh Northern and Leith) (Lab): In terms of the headline figures, it looks as if the financial memorandum was more accurate in its predictions in relation to non-domestic rates and council tax. To start with the council tax, the SPICe briefing states:

"The costings in the FM assumed that all local authorities would apply the maximum (100%) increase for eligible empty properties."

However, that has not happened. Did the Government ask local authorities about that at the time? If not, what was the assumption based on?

Margaret Burgess: As you rightly point out, the financial memorandum was based on the assumption that every local authority would apply the 100 per cent charge. I think that that was based on the very limited information that we had at the time that around 70 per cent of properties would be empty for a year or more—that has not been the case, though—and on local authorities putting in the flexibilities. Maybe the Government officials can say whether local authorities were asked about the issue for the financial memorandum. However, we had to make an estimate in the financial memorandum and it seemed appropriate to take it to that level of possible additional resources in local authorities.

I recollect that, at the time, Alex Neil made it very clear that the focus of the legislation was not on councils raising additional resources but on bringing homes back into use. Councils, too, have made that clear and have been very supportive of having this tool, should they wish to use it.

10:00

Stuart Law (Scottish Government): At the time, councils were asked whether they would use the power, but they said—quite rightly—that they wanted to see what was proposed in regulations before they would make any such commitment. The primary legislation was primarily an enabling power, with the regulations setting out how things would work in practice, and that was factored into councils' business planning.

Malcolm Chisholm: The minister said that the key issue was the reduction in the number of long-term empty homes. The financial memorandum assumed a 10 per cent reduction, but your written evidence suggests that there has been a reduction of only 5 per cent. It is almost as if the financial memorandum contains two overestimates—namely, on saving more money and on releasing

more homes—and it seems to be very significantly out on both counts.

Margaret Burgess: I think that I am correct in saying that there has been 5 per cent reduction in the number of empty homes across the local authorities that are applying the increase. As I have said, this is a tool, and we are still early on in the process. It is being used in conjunction with the empty homes partnership and empty homes officers and, together, we estimate that 1,200 empty homes a year will be brought back into use. That is a significant number, and we hope to see that happening very soon.

Local authorities are looking at the matter and have spent the first couple of years reclassifying properties as empty homes and second homes. In fact, that is what empty homes officers have been doing; they have been looking at whether a property is a long-term empty home, which would incur the charge if the local authority in question is applying it, or a second home. That is part of the work that is being carried out.

As I have said, it is still early in the process. As you have rightly pointed out, the estimates in the financial memorandum were based on every local authority applying the charge at 100 per cent. That has not happened; local authorities have had to look at the flexibility that they need, at the particular circumstances and at whether, in areas where properties are hard to let anyway, it is appropriate to apply a charge if it leads to properties lying empty for longer than they might want.

Malcolm Chisholm: Marco Biagi said that the savings in non-domestic rates were in reasonable agreement with the original estimates. We have already been over this territory to a certain extent, but to what extent has that been as a result of chance or as a result of some causal relationship?

Marco Biagi: I always like to think that the estimates are good. If the numbers add up, I do not immediately seek nefarious reasons for that or try to find out whether someone was at fault.

Coming back to the question whether it is still too early to carry out post-legislative scrutiny, I note that there are lessons to be learned in that respect in the financial memorandum, where the 2012-13 estimates for the cost of empty property non-domestic rates relief proved to be a little bit different to the actual figures. The financial memorandum estimated the figure at £152 million, but the actual figure was £169 million. However, we have brought that £169 million down to £146 million, which, in terms of scale, broadly brings us to the position set out in the financial memorandum. Of course, because this provision was imposed on the same terms across the country instead of being introduced on an

authority-by-authority basis, the projections were probably always going to be a little bit firmer.

Malcolm Chisholm: I noted your reference to Mao Zedong's thoughts on the French revolution, but do you think that, years down the line, it will be easier to see a causal relationship in this respect? Is it always going to be a bit uncertain, because it is related to economic circumstances and so on, or could things become clearer as the economy becomes more stable?

Marco Biagi: The more data points we have, the easier it is for us to model the different factors that are active. Any economist or accountant would tell you that. As I said, I see that what we predicted is happening, and I am fairly relaxed about that.

Malcolm Chisholm: Is there any causal relationship with other reliefs? The reliefs associated with the small business bonus scheme seem to have increased quite a lot over a two-year period, while the unoccupied property relief has gone in the opposite direction. Is there any relationship there, in your opinion?

Marco Biagi: We have estimated that there is an additional £4 million in the small business bonus relief as a result of small business properties coming back into use. Other changes will be down to other factors.

Jean Urquhart (Highlands and Islands) (Ind): Empty homes must be just about the worst thing to have in a country where housing is such a priority. The SPICe briefing notes that, without information on much larger conurbations such as Glasgow and Edinburgh, where the population is, it is difficult to use the evidence that we have on where the largest number of properties are. Are there still incentives for councils to help to bring some of those homes into use? Some of them are in really poor condition. How do we measure that? Do you have information on how many of the 2,000 empty properties in Glasgow are viable? Is work being done to reduce the number of empty properties?

Margaret Burgess: I do not have that exact information off the top of my head. There is work going on in every local authority area to reduce the number of empty homes. I would have to go back and check whether some of the empty homes in Glasgow are due for demolition as part of the transformational regeneration work that is going on in the city; there may be empty homes that are not intended to be filled. The Scottish Government has a number of incentives for local authorities to bring empty homes back into use. Those include empty homes partnerships and empty homes officers, and we are about to launch the town centre empty homes fund. We had a loan fund that brought a number of homes back into use.

I am certainly willing to take away and look at the points that were raised earlier about empty homes in Glasgow, and to consider whether the Scottish Government can do something more to assist or to get more detail on why those homes are empty. I am sure that the information will be somewhere in the Scottish Government statistics, but it will not necessarily be found in the council tax information, because there are a number of factors relating to empty properties. The priority for us all is to have them brought back into use, because they are a blight on communities as well as providing no help for anyone who is homeless.

Jean Urquhart: Absolutely.

Stuart Law: On the point about Glasgow, Shelter Scotland, through the empty homes partnership with Glasgow City Council, is looking at some preparatory work for a joined-up effort between the council and Glasgow Housing Association to consider the possibility of a shared empty homes officer, potentially with funding from the Scottish Government.

The City of Edinburgh Council has an empty homes officer in place and is making great strides in trying to target those problem empty homes. The City of Edinburgh Council operates an empty homes loan fund; Glasgow City Council, through GHA and another registered social landlord, had a share of that fund and brought more than 23 homes back into use through the funding. Behind the scenes there is significant work going on in Edinburgh and Glasgow.

Jean Urquhart: Good.

As I remember it, in the debate in the chamber the Conservatives got very excited about property owners being outraged that they would have to pay such an amount of money in non-domestic rates in a period of recession. They said that we were being very hard on the owners of property. Have you received a lot of representation from individuals or companies in that respect?

Marco Biagi: There was certainly a strong representation during the passage of the bill, but I will defer to my official on that. Have there been representations since then?

Douglas McLaren (Scottish Government): No, not particularly. When we come to do a review this year, we will engage with stakeholders and seek their views on that point, but the issue has not been particularly prominent since the bill was passed.

The Convener: Thank you. We appear to have exhausted questions from colleagues round the table. Would the ministers like to make any further points to the committee at this stage?

Marco Biagi: No.

Margaret Burgess: No.

The Convener: I thank you for your contributions this morning, and I thank my committee colleagues.

10:10

Meeting suspended.

10:16

On resuming—

Fiscal Framework

The Convener: We are nice and early, so we have plenty of time to ruthlessly interrogate our witnesses—not that that is the plan; we will be asking you questions based on two fascinating papers.

I open by saying to Jim Cuthbert that his Holtham indexation relative population growth equation caused a lot of chat in the pub last night. A lot of the lads disputed some aspects of the equation and the findings. No doubt we will continue that discussion tonight while watching the football.

I will get straight into the formal proceedings. Our next item of business is to take evidence as part of our inquiry into Scotland's fiscal framework. I welcome to the meeting Jim Cuthbert of the Jimmy Reid Foundation and John McLaren of Fiscal Affairs Scotland. Members have received papers from both our witnesses, so we move straight to questions from the committee, and I will open.

You have provided details in your papers that answer a lot of the questions that I will ask you but, for the record and for the purposes of discussion, I will ask some of those questions anyway. I say that just in case you wonder whether I have actually read your papers—I can assure you that I have read both papers, but I wish to expand on some of the issues in them.

In your introduction, Dr Cuthbert, you write:

"it is extremely difficult to see how the Smith Commission proposals can be implemented in a fair and equitable way, and without adverse unintended consequences, unless deep-rooted reforms in the constitutional and funding arrangements for Westminster are also implemented."

You go on to explain yourself in great detail.

Can you talk about the no-detriment principle as you understand it and the impact that you believe it would have on public expenditure in Scotland?

Dr McLaren, once Dr Cuthbert has answered, I am more than happy for you to respond to his comments if you so wish—I will also ask Dr Cuthbert to respond to your comments.

Jim Cuthbert (Jimmy Reid Foundation): As is explained in the paper, there appears to be a basic problem if you let changes in rest-of-UK income tax affect public expenditure on reserved services in the United Kingdom as a whole. I call that "the gearing problem" in our submission. The Smith commission did not specifically mention that problem in its report. On the other hand, it brought

in the principle that changes in the rest of the UK to taxes that are devolved to Scotland should not affect public expenditure in Scotland—and conversely. I would argue that that principle is difficult to implement properly unless you bring in something like full federalism.

How the command paper 8990—"Scotland in the United Kingdom: An enduring settlement"—proposals implement the principle is spelled out in paragraph 2.4.14. In my answer to question 5 of the committee's questions, I spell out how that might work.

On the assumption that the gearing problem has been satisfactorily removed—that somehow rest-of-UK income tax receipts have been hypothecated to devolved services in the rest of the UK—which I would regard as being a difficult thing to achieve, you would still have the implications of the proposals on the no-detriment principle in paragraph 2.4.14. What that paragraph says is that when there is a policy change in taxation in the rest of the UK, if the proceeds of that are hypothecated to "devolved services" in the rest of the UK—I put "devolved services" in quotes because I mean those rest-of-UK services that are devolved to Scotland—that would have an effect on public expenditure on those "devolved services", and there would be Barnett consequentials. Paragraph 2.14.14 says that there should then be an adjustment to the block grant to cancel out such effects, so that there is no overall effect on public expenditure in Scotland from the policy change in income tax elsewhere.

The example that we give is, naturally, Trident. Let us say that the rest-of-UK Government decided to increase income tax to fund extra spending on Trident. Since that is reserved expenditure covering the whole of the UK, Scotland, given the "Government Expenditure and Revenue Scotland" methodology, would be attributed a population share of that, and overall public expenditure would go up by that amount. To prevent that from happening, in line with the principle that is set out in paragraph 2.4.14, there would need to be a reduction in Scotland's block grant, to which the Scottish Government could respond either by cutting devolved services or by increasing income tax. That seems to be an unacceptable position, and one that runs quite counter to what one might regard as the Smith principle that we would be in charge of our own income tax and be able to make such decisions.

In a sense, there would be a mechanism here whereby decisions that were made by the rest-of-UK Government would yank the Scottish Government's chain and force it to react either by increasing tax or by cutting devolved services.

That is the mechanism that is spelled out here, and it seems to be an unacceptable mechanism

with regard to what the Scottish people thought that they were getting out of the Smith reforms.

The Convener: Thank you very much for that. Dr McLaren, what is your view on the issue that Dr Cuthbert has just raised?

John McLaren (Fiscal Affairs Scotland): It is, I think, a correct interpretation. However, if it is seen as unacceptable, what happens if you reverse it? Say, for example, that the UK wanted to increase spending on Trident, defence or foreign affairs, obviously the benefits would be spread across the UK, but that money would come only from the UK as rest-of-UK tax rises, so it would be a free lunch for Scotland. That would perhaps be seen to be more unacceptable, certainly in certain parts of the UK.

Inevitably, there is no perfect solution; there will be swings and roundabouts, and compromise will be needed. I think that Smith and the people who discussed and agreed the Smith proposals knew that that is what would happen. If they did not, they did not go into the implications very far. The parties who discussed the proposals inherently agreed that that is what would happen in practice.

The Convener: I am not sure how that would be a free lunch for Scotland.

John McLaren: If the rest of the UK raises its income tax to spend on Trident or ground troops, and Scotland does not raise its income tax, Scotland does not pay for the extra troops. Would that not be an advantage?

The Convener: Right. Dr Cuthbert, what do you think about that?

Jim Cuthbert: We are getting into questions of democracy and where decisions are taken. I specifically used the Trident example in the paper because extra spending on Trident would clearly be counter to what the majority of people in Scotland would want.

Effectively, what happens is that the decision is taken by whoever is deciding to raise the rest-of-UK income tax—whether that is Westminster or a sub-Westminster chamber—who is forcing actions on the Scottish Government. John McLaren says that an increase in spending on Trident would be a free lunch for Scotland, but the majority of the Scottish population clearly would not regard that as a free lunch—they would regard it as a penalty that they would be forced to pay for.

We are getting into questions of where decisions are made and the nature of those decisions, which brings us back to one of the fundamental points that I make in my paper. If this is going to work properly, we need some sort of federal system. We cannot have a Parliament in the south making decisions that force everyone in Scotland both to accept things such as increases

in spending on Trident and to pay for them in a way that goes beyond what happens at present. At present, if Westminster decides to fund Trident by raising income tax, what Scotland pays is what that rise in income tax would yield in Scotland. Under the new system, we would have to pay a population share of the increase in expenditure. Given that our share of income tax receipts is lower than our population share, we would be forced to pay more than we would pay under the present system for such a change.

The fundamental question is about what sort of decisions are being made and by which chamber. To my mind, a satisfactory resolution would involve some sort of overarching federal Parliament making the decisions in the names of all parts of the UK jointly, while questions about RUK income tax would affect only England and the other parts of the UK. The only feasible way of doing that would be to have separate block grants for the different parts of the UK, with the use of their own resources on top of that being a matter for the separate chambers for those different parts. As soon as you bring together the chamber that makes the decisions about the RUK block grant and spending on Trident, you return to the unacceptable situation that we are in at present. It is difficult to see how the problems can be resolved without such a separation of decision making.

The Convener: Okay. We are where we are, and whether federalism comes up on the agenda post May is another issue. Going forward, we really have to look at what we have at the moment and where we are.

Dr McLaren, in your paper you say:

“With regards to the ‘no detriment’ principle, one key issue relates to the position where the raising of existing taxes is not equally spread across the UK.”

Dr Cuthbert makes a similar comment in his paper. You continue:

“For example, Scotland’s share of Income Tax ... is notably lower than its population share”.

In your view, how is that likely to impact on Scotland in terms of the Smith proposals?

John McLaren: If—as has happened in periods of recent history—the wealthier become richer more quickly than the majority of the population, more income tax will come from higher earners. I think that the top 10 per cent of earners already contribute about 50 per cent of income tax.

Jim Cuthbert: It is something like that.

John McLaren: However, Scotland has, proportionately, fewer of the richer people—the higher taxpayers—than the UK as a whole. That is why, in GERS, Scotland’s income tax contribution is 7.3 per cent, rather than 8.3 per cent, which is

its population share. That means that UK income tax is likely to grow more quickly if the richer people's earnings continue to grow more quickly. That could have a knock-on effect. If Scotland's contribution were adjusted to reflect its population, that would take more money away from Scotland than would be raised through income tax in Scotland.

It can take a bit of time to get your head round some of these things. I have experienced that myself. If I need to explain the situation again, feel free to ask me to do so. Equally, when you ask me questions, I will probably take a while to answer them because they are kind of mind-melt questions—let us all fess up to that.

Conversely, if Scotland decided to cut significantly the higher rate of income tax, that might attract wealthier people in London to move to Scotland, which would disproportionately increase the income tax that was raised in Scotland.

Equally, if it was decided to raise the higher rate of income tax above that which applies in the rest of the UK, Scotland might lose even more. Because so much money comes from that higher rate of income tax, it is quite a key issue that affects whether you win or lose. Recent history suggests that Scotland would lose, because the higher rate of income tax has been the prime generator of any increases in UK income tax receipts.

10:30

Jim Cuthbert: I agree with all that, but I would put a slight gloss on it by saying that it is very difficult to project how relative income tax receipts will move. History has shown that income tax is a fairly volatile tax. As John McLaren says, we have to take a long-term view. Because of the differences in the income tax base and the fact that there are many fewer high-earning salaries in Scotland, one can say that there will definitely be periods when the tax base in Scotland will grow less fast. Under Holtham indexation, Scotland will be penalised.

The danger is that, once such a period starts, the Scottish Government will have to react either by cutting services or by raising tax. There is a danger that taxes will be raised, which will have a knock-on, detrimental effect on the economy that will further damage the tax base. You then get into a self-perpetuating cycle of relative decline.

I will make two points about that. First, the issue of the wisdom of the choice of income tax being the primary vehicle for giving Scotland fiscal responsibility brings in the question of Holtham indexation as being vitally important. Secondly, it also brings in the question whether Scotland will

be able to grow its economy. The solution involves asking whether Scotland can get its economy moving on a par with that in the rest of the UK, but Scotland has relatively few economic powers to enable it to do so. The phrase that we tend to use about the whole Smith proposal is that it is responsibility for living within your tax base without the power to do much to influence that tax base.

There are deep issues about the appropriateness of choosing income tax, about the indexation and about the other powers that are necessary if this is going to work while avoiding the danger of Scotland slipping into a virtually permanent cycle of relative economic decline.

The Convener: I think that Mark McDonald wishes to ask a supplementary question.

Mark McDonald: I was just looking to come in.

The Convener: You were already down to come in.

Mark McDonald: Was I? I am jumping the gun.

The Convener: Exactly. I thought that you wanted to raise a specific point.

Dr Cuthbert, in your paper you go on to discuss what happens

"If it is impossible to implement a satisfactory Scottish fiscal framework in the absence of fundamental UK changes".

You have already touched on that. You say:

"The technical complexities of satisfactorily implementing the arrangements which are currently proposed are so great that it is likely to prove impossible to operate the resulting system in a fair, transparent, and acceptable manner."

It may be that we are trying to squeeze a quart into a pint pot, but the Smith proposals are as they are. How can we optimise them in Scotland's interests, assuming that it is the Smith commission proposals that are implemented after the election, rather than any further change in powers?

Jim Cuthbert: I understand that the indexation arrangements for the abatements to the block grant are not yet set in stone. The one specific proposal that has been made—this goes back to the famous annex to my paper, and I note that John McLaren makes the same proposal in his paper—is that, rather than indexing the abatement for income tax in line with movement in the whole UK tax base, that would be done in terms of the per capital tax base. That would be a potentially important step. It would not solve the problem; nevertheless, it should be done.

Given that the indexation arrangements for the abatements to the block grant are not set in stone, the arrangements for reviewing what happens are very important. Our paper makes the point that the mechanical nature of the arrangements is not necessarily a good thing. We are, after all, in a

monetary union. During the referendum campaign, the point was made ad nauseam that monetary union implies political union. You cannot operate a monetary union without mechanisms for fiscal transfers. That is not to argue that the previous arrangements that we had were satisfactory: the oil receipts went out of Scotland without that being noticed, and we were inadequately and inappropriately compensated through the Barnett formula in response.

I am not saying that the previous arrangements were good, but we are in danger of moving into a situation in which the arrangements for fiscal transfers within the monetary union are seriously weakened. Scotland could find itself in an even worse position than that of Greece: in a malfunctioning monetary union, with inadequate arrangements for fiscal transfers and without control of its own resources and economic policies.

As long as we are in the monetary union, we should be arguing for appropriate oversight mechanisms. Those would have to be high-level mechanisms, where a view was taken at a high political level about total flows of resources within the UK, the economic pressure in the different parts of the UK and whether that was just or not, to allow adjustments to be made.

The Convener: Thank you for that.

Dr McLaren, on the points that I have just raised with Dr Cuthbert, how can the fairness, transparency and so on be delivered within the arrangements proposed by Smith?

John McLaren: As I said in my submission, we have to define each of those things. It is fairly obvious what “transparent” means, but there are degrees of transparency. People’s interpretation of what is “fair” will vary. What does “effective” mean? On “mechanical”, as both Jim Cuthbert and I have said, we probably want something that is reasonably, but not wholly, mechanical.

This is one of the big things that the Smith commission did not do. It got a political agreement to something, but did not explain what the economic and fiscal rationale was for the package—possibly because there was none. That then makes it difficult to say why those things are being done and to defend something and say what the perfect way of implementing it is, because we cannot go back to a basic set of principles or a rationale.

From the Scottish end, if you define what you believe those things to be—what the elements of prioritisation are within them—that would help. Both Jim Cuthbert and I have brought up in our papers the things that you need to look out for. The first is the issue of income tax and Scotland’s relative position on that. The second is population

change, which is not a straightforward issue. If Scotland were to do particularly well through implementing the powers that it has, we would want the population element to work in our favour, whereas it currently works against us. It could work in our favour, although without more powers in relation to immigration that is not likely to arise in the short term. The third thing is the demographics, which are related to population and work against Scotland.

My final point is that Scotland needs to arm itself as best it can. By that I mean that when the inevitable negotiation takes place, and because there is so much uncertainty here, a Scottish office for budget responsibility and a beefed-up Scottish finance department, which would be more like a Scottish treasury, would need to have sufficient or better ammunition than the other side, in terms of determining what would be fair and what the likely consequences of something would be.

Although the Barnett formula is fairly mechanical, such negotiation happens even under it. A classic example, which I have used before, is that to work out the consequentials, someone had to decide whether something that was in place in the rest of the UK was also in place in Scotland. When a lot of money was being put into the London underground the claim from the Treasury was that no money should go to Scotland because there were no consequentials, until someone pointed out that Glasgow had its own underground and so a settlement was made. That was not mechanical.

That is an obvious example, but there will be other areas where you will need to know the detail in what will ultimately be some form of negotiation.

The Convener: With regard to fairness, surely it is all about whatever is not detrimental to RUK and Scotland. I suppose that the question is how you judge that.

Dr McLaren, on the issue of population change, which you have already touched on, I ask you to expand on the comment in your submission that

“any adjustment process may want to move in line with changes in UK IT”—

that is, income tax—

“per capita. The downside to this is that it does not allow Scotland to benefit from any net migration rise through being seen as a more attractive place to live and work.”

John McLaren: The hope—even with the partial form of greater devolution, short of full fiscal autonomy or independence—is that the extra powers, along with the existing powers over economic spending and so on, will improve Scotland’s economic performance, make it a more attractive place to come and work, attract more migrants into Scotland and thereby raise its

population. If that approach were to work, Scotland's income tax would rise faster than the UK's; as a result, you would not want it to be adjusted on a per person basis, because you would want to take all that benefit yourself. The difficulty, however, is how you get the growth rate up and how you increase migration when migration targets are still partly retained by the UK Government rather than coming to the Scottish Government, which might want more lax restrictions on who can come to Scotland. That is the potential, as well as the drawback in the current position.

Jim Cuthbert: I disagree slightly, because there is probably an asymmetry in all of this. It is important that we avoid at all costs finding ourselves in a position of relative decline. However, I do not think that, if we were to turn the economy around and it started to grow faster than that in the rest of the UK, we would necessarily want to grab all the benefits for ourselves. In those circumstances, the economy would be prospering and there would be all sorts of beneficial multiplier effects. We would not be worrying too much about losing out slightly, because Holtham indexation would still be on a per capita basis. It is in the spirit of operating a proper monetary union and the nature of realpolitik that there is an asymmetry, and it would be more damaging to be caught up in a cycle of relative decline than to lose out slightly as a result of population indexation if our economy happened to be booming.

The Convener: Thank you. I want to touch on one more area before I let my colleagues in—and I note that all of them want to ask questions.

In your submission, Dr Cuthbert, you say:

“the Treasury has signally failed to operate the Barnett formula transparently.”

Indeed, we have heard other witnesses say something similar in recent months. You also mention

“the Treasury Funding Statement ... which indicates at a fairly detailed level which items of expenditure are reserved or devolved”

and

“the Public Expenditure Statistical Analyses”

and note that

“the TFS and PESA databases are not aligned”,

which means that

“it is not possible to calculate, other than by fairly crude estimates, what the outturn expenditure for England has been on those services which are devolved respectively to Scotland”.

What would be the impact if those databases were aligned and if there were greater transparency? How could that enhance Scotland's fiscal position?

Jim Cuthbert: It would have had a huge impact on economic and political debates in the past. After all, there is always room for argument about the extent to which the Barnett formula delivered convergence of per capita spend. What happened in the past should have been clearer, and if it had been, things would have moved forward differently.

Of course, that is just one suggestion. The whole process of setting Scotland's block grant should be open and transparent, and I can highlight a couple of examples of things going badly wrong in the past. One such example can be seen in the Institute for Fiscal Studies paper on the Barnett formula's handling of non-domestic rates. According to the IFS, Scotland has, in fact, benefited to the tune of £1 billion because of mistakes that the Treasury made and which were not at all apparent. I do not know whether those figures are right, but there is certainly a huge argument to be had about whether we benefited unduly, which would not have been the case had the system been plain and open.

Another issue, which we identified some years ago, is that the way in which European structural fund receipts were handled in the Barnett formula penalised Scotland, we argued, to the tune of £1 billion. Officials in the Scottish Government agreed with us that that was indeed the order of magnitude to which Scotland had suffered. In the past, the lack of transparency has meant that there have been huge mistakes, probably on both sides, and that was in the days when we just had the Barnett formula. We are now moving into a much more complicated system where we are still trying to make basic changes to link changes in the block grant to public expenditure in the rest of the UK or in England, while at the same time we want to discount parts of that public expenditure because it gets publicly funded in England by its own resources. Trying to work around that is horrendously complex, so if under the previous system we did not know what was happening to the tune of billions either way, in future the potential for argument and mistakes will be immense. It looks like an almost unworkable system; it is certainly one that is fraught with difficulty and dispute.

10:45

The Convener: Dr McLaren, could you comment on that issue? Could you also comment on your own paper, in which you say that

“This convergence feature will remain as part of a revised Barnett formula, with no lower limit over how close the spending per head levels can get”?

John McLaren: Although there are problems with transparency under Barnett, they will be as nothing in comparison with those under this much

more complicated system, unless a very simple form of it is introduced, at which point fairness might be an issue.

I discussed the IFS figures in great detail with David Phillips and I think that they are right, but it was not intended that way. It could have happened the other way round, and Scotland could have lost out, and may still lose out in future, because it is not driven by politics; it is just the way in which things happened because of how business rates moved in England.

The reason why convergence does not happen is that the UK's population keeps rising faster than Scotland's does, which means that, while Scotland gets only a population share of the extra, which would produce convergence, the existing block of money to which the extra is added is then divided by a larger number of people in the rest of the UK than in Scotland. That is basically what has tempered—or, in some cases, even reversed—the convergence under Barnett. Barnett is supposed to work in such a way that, if the population of both countries were growing at the same rate, there would be convergence over time, unless spending falls, which it has in recent years, although it is assumed that it will continue to rise, so that the difference would continue to fall until it is zero, which on anybody's estimate is below what the relative needs of Scotland and England require. Of course, because we are nowhere near that, nobody pays much attention to it, but technically that is what the mechanism is there to do, although it has not done it.

The Convener: I am going to open up the session to my colleagues around the table, who have been very patient for the past half hour.

Malcolm Chisholm: We have received two interesting papers and have covered most of the main issues, but they are quite complex so I have no doubt that they can be revisited in a different way. The one area where both witnesses seem to agree strongly is on Holtham indexation being based on growth per capita in the UK tax base rather than the overall growth in the UK tax base, notwithstanding the theoretical population opportunities for Scotland. I think that you are both agreed on that; if you are not, you will tell me. You have set out an interesting proposed adjustment to the Holtham methodology, which seems to be accepted by both Governments, so that is something that could certainly be pursued.

A bigger problem than the population variation is the issue of higher-rate taxpayers, particularly in the south-east of England. Is there any solution to that problem or do you just have to live with that within Holtham? I cannot think of a solution, but I presume that, if we excluded the top 1 per cent of taxpayers from indexation, it would help. Is there any possible solution to that? It might not be

acceptable to the rest of the UK, of course, but is there any theoretical way of dealing with that problem of the top-rate taxpayers, particularly in London?

Jim Cuthbert: One could devise a synthetic tax base that is, in some sense, like the Scottish tax base and then see how it grows in UK terms. However, one is getting very complex and, again, increasing the room for argument.

The other solution is one that I have already mentioned, which is that one attempts not to make it too mechanistic; one has an oversight mechanism that keeps good tabs on what is happening and takes a view as to whether Scotland is being penalised. The difficulty with that is that one suspects that the different parties that signed up to the Smith agreement are coming from different world views.

I suspect that the majority party in the current Westminster Government is taking a sort of neoliberal view that the main thing is to balance a country's budget and, preferably, shrink its state and that the economy and equity will then look after themselves. I certainly do not subscribe to that view. I believe that you need powers and, within a monetary union, you need continuing oversight and active adjustment of fiscal transfers to achieve some desired aim.

John McLaren: Some synthetic index could probably be created. I suppose that the main thing is to divide up the different income levels and track the UK in a different way—say, in a population share up to the top level of tax and then tack it slightly differently because Scotland has a lower share of higher-tax earners. We could probably find a way of doing that, but it would introduce a level of complexity that might change in the future. A review would be needed to decide whether the situation had changed and whether we should change the model. It could be done through negotiation, but it would probably have to keep on being negotiated over time; it would not be straightforward.

Malcolm Chisholm: That is helpful. We probably need to keep thinking about that.

I have a brief question for you, Jim. Two or three times, you have talked about monetary union and fiscal transfers. Could you identify specifically what fiscal transfers would be necessary for the monetary union rather than for other reasons, if you see what I mean?

Jim Cuthbert: I think that one probably could. One is asking a lot. One is asking for political and economic goals to be identified—some sort of overall goal that economic pressures in the different parts of the UK should be equalised so that no part gets too far ahead, as the south-east of England is doing at present, or lags too far

behind, as Scotland might under the Smith agreement or, indeed, has in the past. Equally, we are thinking not only about Scotland and England but about the different parts of England.

We need to have some sort of view about how we want the overall economic pressure in the country to evolve and then have some way of adjusting for it. The way of adjusting might not necessarily be fiscal transfers. Some time ago when David Heald held a symposium on fiscal autonomy, Margaret Cuthbert and I did a paper in which we said that one possible way of doing that within the union was not through fiscal transfers but by adjusting tax rates. That would not be local determination of tax rates but a central body taking a view that the rates should be adjusted in a particular way to even out economic pressure.

There are a number of ways that one could do it, but one would have to have the political will and the kind of body that could make those decisions independently of narrow, sectarian political or geographical interests.

Malcolm Chisholm: There are two important issues that I have not got my head around completely. One is the gearing issue, which much of Dr Cuthbert's paper was about. I can see why you used the example of Trident in relation to raising income tax. However, if you had used the example of the state pension instead, would that throw a different light on the situation, in the sense that it might not appear to be quite as bad as you are obviously implying that it is?

Jim Cuthbert: Yes—obviously that might apply for some changes. The Scottish Parliament or the Scottish people might say, "Yes, we agree with that change and we are willing either to cut education and health or to increase tax to fund that", or they might not. However, that still brings us back to the question of the democratic element. If such changes were being made essentially by a Parliament in which we have limited or inadequate democratic representation, there could still be something that irked and was unfortunate.

In particular, if there were too many of those changes, the Scottish Government's freedom of action to determine its own policy on income tax et cetera, which is presumably anticipated under the Smith process, would be overridden by the adjustments that it would have to make—if, as I said, its chain was being choked by decisions that were made by another chamber.

There are good changes and bad changes, but the underlying problem remains.

Malcolm Chisholm: Presumably, if tax goes up to pay for Trident—or indeed for pensions—that would be dealt with by some adjustment to the Barnett formula.

Jim Cuthbert: As is implied by paragraph 2.4.14.

Malcolm Chisholm: If income tax were reduced as a result of a decision to abolish Trident, for example—or to reduce the pension, which presumably will not happen—would Barnett not take care of that as well?

Jim Cuthbert: Yes. If it is bad going in one direction, it is liable to be good going in another, but in a sense both are unacceptable. If we are suffering from arbitrary gains or losses as a result of decisions that are taken by another chamber—possibly not in a fully democratic fashion, particularly given English votes for English laws—that alike is unacceptable. Obviously one gives the example that will be strikingly bad but, in a sense, the system that throws these random pluses and minuses at us in an undemocratic fashion is not a good one.

Malcolm Chisholm: Dr McLaren, with regard to your point about Barnett—again, I have never totally got my head round why convergence is not happening—your submission refers in bold letters to "existing 'faults'", so I do not know whether convergence is a fault or part of the intention of Barnett. Your explanation was interesting, because I have never totally understood the point. I am still struggling a bit. You are saying that the reason why there is not convergence is that the UK's population keeps rising faster than Scotland's population. If that is the case, surely Scotland's share of any UK expenditure on devolved areas will be a lesser percentage. If the English population is rising higher, we will get 8 per cent rather than 9 per cent or whatever.

John McLaren: Yes, but only of the extra money, and not of the money that has already been committed.

Malcolm Chisholm: Right.

John McLaren: The extra is a pittance in comparison with what one would be adding it on to, which will be divided among more people in England because the population is rising faster there than that it is in Scotland. It is not about the increase but about the base.

Malcolm Chisholm: I understand that. That is helpful.

Are you suggesting in that paragraph that it could be to Scotland's detriment if people started aggressively applying the convergence principle, which does not happen in practice but should happen in theory?

John McLaren: There have been shifts over time. Initially, the Government did not update populations, which was a pretty obvious thing to do, and then it did. It also operated the formula on real terms and then changed it to cash terms.

Those things made the convergence tighter, but they are still not enough to overcome the effect of what I described. You could start to introduce something that adjusts the base as well as the increase over time to ensure that convergence happened to some extent. It could be at any pace, but you could quite easily introduce it.

Jim Cuthbert: Can I just comment on that? I published a paper in the Fraser of Allander institute bulletin some time ago in which I set out the algebra of relative population change in relation to the Barnett formula. Unfortunately the algebra is difficult but, nevertheless, the effect—which is a major one—is fascinating. The way in which relative population change can cause actual divergences is very interesting. I am happy to send the committee a copy of that paper.

11:00

Malcolm Chisholm: We all love your algebra, so if you can send us that, that would be good.

Finally, Dr McLaren, I noted your interesting point that

“With regards to the borrowing for current versus capital spending issue, it is unclear whether such limits can be strictly applied”

and your suggestion that they should not apply in Scotland. I certainly agree with that view, but why can those limits not be applied in practice?

John McLaren: Do you mean through Barnett at the minute?

Malcolm Chisholm: Is that what you are referring to in your submission?

John McLaren: Yes. At the moment, anything that you get on the capital side cannot be transferred to the current side, although you are allowed to do things the other way round. It is a bit like saying, “You really shouldn’t do that, and we’re not even going to allow you to do it.”

Malcolm Chisholm: I agree that the limits should not apply, but you seem to be suggesting that they could not, in principle, be strictly applied. Is that because we cannot really distinguish between current and capital?

John McLaren: There is increasingly an issue about what is capital and what is current, but the point that I was making was about the Barnett formula and how the current situation should be changed.

Malcolm Chisholm: And is what constitutes current and capital spending clear in UK terms? The issue is sort of relevant to current election debates, but is it absolutely clear which is which?

John McLaren: It is clear in the sense that they are defined, but it is not really clear what, in terms

of education, say, constitutes capital investment in bricks and mortar versus other elements.

Malcolm Chisholm: Do public-private partnership payments count as capital or current spending?

John McLaren: I think that they are separately identified in the budget, but I do not think that they come under capital spending. Do you know, Jim?

Jim Cuthbert: No.

John McLaren: In any case, such payments are not insignificant sums for both Scotland and the UK. They eat into the budget considerably.

Malcolm Chisholm: I must try to find that out. I presume that those annual payments must come under resource or current expenditure.

John McLaren: They must do. Given that they are paid annually, I am pretty sure that they are on the current side. Moreover, if you set yourself a capital limit, those payments would eat considerably into that spend over time.

Malcolm Chisholm: So, in practice, there is no capital limit. You can turn resource into capital, but you cannot turn capital into resource.

John McLaren: But I think that quite often people put other sorts of limits on, but that is more of a debt point.

Malcolm Chisholm: Thank you very much.

Jean Urquhart: I love the idea of a mind-melt question, but I suspect that my own question is not one of those.

I also like the idea of a Government trying to raise tax specifically for Trident—that would be a really interesting approach. In fact, my question, which is for John McLaren, relates to the theory behind that. When we discussed the issue earlier, you said that if all those costs were met by the rest of the UK it would look like “a free lunch” for Scotland. However, would the no-detriment principle not kick in? Moreover, given that the no-detriment principle is full of complexities, who will be the arbiter of it?

John McLaren: As was made clear in the previous set of questions, the issue relates not just to Trident but to international aid, pensions and any of the other things that the rest of the UK would raise money for. Is Scotland to be allowed to decide whether to participate in those things or not?

It seems to me that the decision that was taken in the Smith agreement was that such areas would remain reserved. As a result, if more money were to be spent on them, that would be for the UK to decide. The implication is that Scotland would probably have to raise its taxes equally and that if

it did not, it would have to make cuts elsewhere, which would mean, ultimately, that the rest of the UK would get the money back. There might be issues of democracy to address in that regard, but it seems to me that that is what the Smith commission decided and that was the deal that was agreed on. People said, "So be it—these are the areas that we'll still control." Whether that is right or wrong, that was the side that the Smith commission came down on.

On the arbiter of no detriment, I guess that that will initially involve negotiations between a Scottish OBR and the UK OBR, or bodies of that ilk, both supplied with information and complemented by the Scottish treasury and the UK Treasury. Ultimately, the matter will go to a meeting of senior politicians to negotiate, almost similarly to what happened in the Smith commission, but perhaps without a Smith figure. The process will be partly based on the evidence that the officials bring together; then, I guess, the politicians will negotiate the final approach on no detriment.

Jim Cuthbert: On who should be an arbiter, my main comment is on who it should not be: it should not be the Treasury. We also run into difficulty with the OBR. Although I regard the OBR well, it is largely a Treasury-staffed organisation. If I have a criticism of it—I do—it is that it has not been sufficiently critical of the assumptions that are fed to it by the UK Government. Therefore, there is a problem with the OBR playing a major part in the process.

The Treasury should certainly not be the arbiter. In the past, the Treasury has played a bad role in making such decisions in relation to Barnett. For example, it decided that structural funds for Scotland should not actually come to Scotland, because the money should just come out of the existing block grant as determined by the Barnett formula, rather than being on top of the Barnett formula. Because of that, Scotland lost out to the tune of £1 billion.

The main thing is that the process should be open so that everyone can see what judgments are being made. Ultimately, the court of public opinion should decide whether the system is operating properly.

John McLaren: If Scotland does not trust the UK Treasury and the UK OBR, I presume that the UK will not trust the Scottish treasury and the Scottish OBR, and so we will not get very far. I have no problem with going to the people—although Smith did not do so—but how do we do that? How do we explain the issue and get them involved? How exactly do we go to the people and get them to decide or arbitrate? There might be problems on both sides, but I still think that the approach that I outlined is probably the best

practical solution, although Jim Cuthbert might want to come back on that.

Jim Cuthbert: I do, because I do not see how we can trust the Treasury, given the history that I mentioned on structural funds receipts. I do not say that the OBR is in any sense a political organisation, but it is hamstrung by its remit. Having adopted what is basically a forecasting remit, it will not give an appropriate appreciation of the various risks that are involved. It is the old issue: in forecasting in a policy-influenced environment, it is normal to assume the success of policy and not to allow adequately for black-swan events. You may know that some things cannot go on as they are for 20 years and that something is going to happen in that time, but you do not know when, so you just assume that it will not happen in the next five years.

Although I make no criticism about political bias on the part of the OBR, there are good reasons why it is not really the appropriate body to adequately fulfil the arbiter remit.

Jean Urquhart: At a recent evidence session, we heard about air passenger duty, over which the Scottish Government desires control. The suggestion was that if we were to reduce air passenger duty and thereby attract business that might normally go through Newcastle airport, that would be seen as being a detriment to Newcastle, so Scotland would have to make recompense. We have talked about openness and fairness and explaining everything to the public. What would be the point of having to do that?

Jim Cuthbert: That particular example is just ridiculous. John McLaren talked about first-order and second-order effects; there are first-order effects that one might want to compensate for.

However, the whole point of Smith, in a sense, is to enable Scotland, we hope, to do better. We probably do not have the powers to do that, but if the Scottish economy did start to thrive post-Smith, there is endless scope for argument as to whether that would be an overall "everyone is better off" situation or be at the expense of everywhere else in the UK. One could argue about that for ever. Really, there should be no concept of our going into that sort of debate and working out second-order penalties based on that.

John McLaren: On the Newcastle example, rather than Newcastle complaining to Scotland, it would be more workable if Newcastle complained to the rest of the UK that it had suffered because of the settlement and asked it what could be done to improve Newcastle's situation within the rest of the UK or within England by perhaps giving it extra things so that it could compete better against Edinburgh airport. That would take us into a slightly more federal system that could be

introduced throughout the UK, which perhaps would not be a bad thing. However, I would see the Newcastle example more as an issue for the Government of the rest of the UK to compensate for, rather than as an issue for Scotland.

Jean Urquhart: If there were local income tax rates, how would that be squared with Smith?

John McLaren: It would be up to the Scottish Government, because it will control income tax, to decide at what level to do that, and whether it wants to introduce some local income taxation.

Jean Urquhart: Would that be done outwith the income tax calculations?

John McLaren: The income tax calculations would be as before in terms of compensating amounts, but within Scotland we could either devolve income tax further between local and central government or retain it all centrally. That has not been much looked at or thought about post-Smith. It also feeds into things like borrowing: when Scotland gets its borrowing limit to whatever it is—fixed or flexible—how much of that will go to local government? Should local government be involved in the negotiations about the level of borrowing that Scotland needs as a whole? That has not been given much—if any—priority in post-Smith discussions so far.

Jim Cuthbert: I do not think that the local income tax scenario that Jean Urquhart envisages would necessarily greatly complicate what is happening with Smith. I think that the key calculation with Smith will be what the initial abatement for the Barnett formula should be for letting Scotland have control over income tax, and that will be based on the existing tax structure. There is also the question of indexation that we have been talking about.

However, the key modelling will be done either overall for the UK or on an RUK income tax base, so that will not be affected by local income tax decisions. There is also the question of what adjustments to the block grant are necessary for policy decisions on income tax down south that affect devolved services. Again, those calculations should be RUK calculations. I think that the key calculations would not necessarily be affected by the possibility of local income tax within Scotland.

Jean Urquhart: I have two quick points, one of which is on immigration, because it seems to me that Scotland needs people and that we could have immigrants from England. The other point is that there is opinion that the Smith commission was done in too much haste and will inevitably be unravelled to a certain extent, given debate in Westminster and regardless of the Government. Is that how you see the situation?

John McLaren: In most years for the past couple of decades we have had net immigration from England across the spectrum—it is not just old people retiring—although the numbers have not been huge. Probably the most obvious technical way to increase immigration from England would be to reduce income tax—in particular, at the higher rate. You might not consider that to be morally acceptable, but it would probably increase the number of people coming here and the amount of tax that would stay within Scotland. However, there are other possibilities.

11:15

It is clear that the Smith commission was done in haste, but it was also demanded in haste, so Smith was meeting his remit. My main criticism is that there was an element of, "What we need is world peace, and we are all agreed on that, but I'll leave it to the Governments to work out the details of how we achieve it." It was not quite as bad as that, but there was a bit of, "Well, this is what we have decided, you work out the adjustments and no detriment, because I'm off." That has not helped us to get to the next stage.

Also, although there were meetings with the general public, I do not know what was taken from those meetings and fed into the final agreement. As far as I can see, the agreement was just made by politicians behind a closed door, which is not a particularly good way to ensure that the populace or the electorate agrees with the proposals.

Jim Cuthbert: I do not want to say much on the question about migrants, except to say that migration might be a useful way of helping to get the economy going, which is the critical thing, with high-level jobs that either migrants or our own well-qualified young people could take. We want to stem the Scottish syndrome of educating our population to take jobs abroad.

The Smith process was done in far too much of a rush—it was seven weeks from beginning to end. It is just not possible to redesign a constitution in seven weeks. It is a botched job in some important respects, but in other important respects, it is a remarkable job. A group of politicians were brought together under an accountant: the result is, in many ways, a remarkable political document. Some of the things that the Smith commission said about the Sewell convention, the Crown estate and other political aspects were remarkably good.

However, the commission was the wrong skill set working to the wrong timescale. The commission completely underestimated the importance of giving economic powers and did not adequately realise the drawbacks of the tax that they chose—income tax—or the inherent limitation

of giving one major single lever, which is not giving much power at all. With the single lever of income tax, the Scottish Government will never be able to deviate too much from what is happening down south, so it is a constrained lever. What do you want to do? You want to improve social equity, grow the economy and raise money to counter austerity or to do socially just things. You cannot achieve objectives in three dimensions with a single control lever.

In certain respects Smith was a terrible job, but in other respects, reflecting the nature of the panel—a panel of politicians—it was remarkable.

John Mason: We have covered quite a lot of areas. Some of my questions will build on what has gone before. We have heard from previous witnesses that we can make the principle of no detriment work at the beginning, so that when a power is transferred there should be compensation or whatever. We have also heard, however—considering the Smith commission idea that policy decisions that affect tax receipts or expenditure will either reimburse each other or there will be an additional cost—that that will not be possible going forward, and does not happen anywhere else in the world, so we can pretty much forget about it. Do you agree?

Jim Cuthbert: That is not what is in command paper 8990, which has a particular interpretation of the no-detriment clause spelled out in paragraph 2.4.14. That paragraph mentions the consequences that are explained in my paper and in the annex to John McLaren's paper. If the powers that be are now saying that paragraph 2.4.14 is a dead letter, that is, in a sense, all well and good, but it is a huge change from what they said in command paper 8990 would happen.

John Mason: Are you aware of the no-detriment principle being used in this way anywhere else in the world?

Jim Cuthbert: No—but I am not an expert on that. In most other parts of the world there are federal systems. We dug a hole for ourselves in respect of complexity, the need for oversight and the gearing problem. All those problems would disappear under a federal system. If we had a federal system, we would not be in this situation, which I would describe as a mess.

John Mason: Does government not still have a problem sharing out resources in Australia?

Jim Cuthbert: It probably does, because resources are difficult to share out, but in a proper federal system in which there is openness and good will, you can get round such problems.

John McLaren: There is quite a lot of devolution of taxes in quite a lot of countries. That devolution comes either with very strong strings

attached or with the attitude that devolved government can raise the money but compensation will be made so that everyone is about the same. What is being set up here is close to being unique—although Spain's very asymmetric system might be similar in some regards. However, usually there is either a strong central grip on the final settlement—as there still is here with Barnett, to some extent—or there is the other approach.

There is a SPICe paper on the issue that covered a number of countries. Perhaps SPICe can get for the committee more examples of similar things happening elsewhere, but I do not think that there will be many lessons from other countries that would make it easier. If there is a lesson to be learned, it is probably to keep the system as simple as possible, and that no detriment is a very difficult thing to do.

John Mason: That leads on to my next question. You used the word "simple". Dr Cuthbert's submission says that transparency and effective scrutiny are mentioned, but equity is not. It strikes me that simplicity is also not included as one of the key factors. How important is simplicity? I presume that if we want the politicians—let alone the public—to understand the system, a simple system is an advantage.

Jim Cuthbert: Yes—absolutely. However, it is not obvious that we can, in fact, get a simple system. One of the things that will drive changes in the Scottish block grant—the Scottish budget—is changes in public expenditure down south. That is the principle of Barnett. However, some of those changes in public expenditure down south are driven by what will in the future be local decisions on income tax there, so we need to take those out. If those changes are set up as the basics of the system, it will be a complex system—complexity is inherent in that approach.

John McLaren: There are two simple systems: Barnett and full fiscal autonomy. As soon as you move away from those extremes—it does not really matter by how much—the situation becomes much more complex because you will have to work out what the adjustment is for them.

John Mason: Both of you have been quite critical of the word "mechanical", which suggests that the system would just happen according to whatever formula was set up, but does "mechanical" not also suggest that such a system would stop the squabbling? We have not had great success with the two small taxes that we already have—land and buildings transaction tax and landfill tax. It has been only a one-year adjustment and that adjustment, as I understand it, was just the midpoint between the two sides. The idea that people would negotiate and talk about it every year has not been very successful, which

suggests to me that maybe a mechanical system would be better.

Jim Cuthbert: The system that we have had has not been fully mechanical, but it has been more mechanical, as I have already said, and has led to some very large potential errors creeping in under the radar. With the much more complex system that we are moving to and with the larger sums involved in dealing with income tax and VAT, the potential for errors under a mechanical system is magnified manifold. Once those errors became apparent—I do not know which way the errors would go, but on the income tax side they would, potentially, penalise Scotland badly—the apparent harmony that you had under a mechanical system would rapidly disappear.

John Mason: We have previously had evidence that in any system that we have, there will have to be a major review every 20 years or so. Would we need to pick up on what was happening every year or could we rely on that longer-term review to pick up on the ups and downs that were happening in the short term?

Jim Cuthbert: I would have thought that 20 years would be far too long a period. An awful lot can happen in a 20-year period. An annual review is probably too often and a review every 20 years is far too infrequent. Maybe there should be something like a five-year review.

The question is: who would conduct that review? It would have to be conducted on a very statesmanlike and non-partisan basis. One does not really see evidence from the political institutions in the UK at present, particularly in what is coming out of some parties in the election campaign, of the ability to take a statesmanlike overview.

John McLaren: The idea that a mechanical system will stop squabbles is right if the mechanics are good. If the mechanics are bad, they will increase the squabbles because the system will be so blatantly unfair.

We are going through a learning process that is taking quite a long time, because we still do not have all the Scotland Act 2012 stuff sorted out. However, I hope that we will get a better understanding and a better mechanism in place as a result of that learning process. That mechanism will always need adjustment, but it is a matter of getting it as mechanical as possible without its introducing unfairness and of people accepting that there could be an adjustment almost at any time, but the mechanism will be reviewed every five years, say. Something else could arise at any time. There could be changes in UK tax rates or UK benefits post an election. Politics will play a big part in that.

In my paper, I mentioned fiscal rules. Fiscal rules will change willy-nilly and Scotland, as the junior partner, if you like, will probably still have to go along with the UK's rules. I imagine that that will happen in practice. Therefore, people might find themselves having to change the mechanics regularly if they want to keep the system mechanical.

John Mason: Dr Cuthbert used the word "statesmanlike". I take his point. He would like a federal system, everything being clearly laid out and all of us knowing where we are, but the reality is that we are dealing with devolution. The purse remains and will remain at Westminster, and we have to accept what it gives us. Is that the case?

Jim Cuthbert: Yes. That is where we are, but the dust has not quite settled and we should be arguing for the best that we can argue for. As I said earlier, part of making things work will be arguing for the most appropriate oversight mechanisms.

John Mason: Earlier on, Mr McLaren mentioned borrowing. I saw that that was dealt with in his paper, and I was quite interested in that. Is there an issue? Currently, we have local authorities with prudential borrowing, so they do not have a fixed limit. They can borrow what they can afford and that has largely worked, as far as I can see. We have received evidence on that, too. Scotland will potentially have a limit, although I would like to see it having prudential borrowing powers, too. Do we need to tie the two together? Is that inevitable? I presume that Westminster could give us an overall limit, but it just suggests a limit for the Scottish Parliament and not for local government.

John McLaren: I suppose that, theoretically, your borrowing should be related to the income that you can guarantee, especially if you are going to borrow from the market, which is where most of it will ultimately come from. That is one way of putting it. The question is how much money local government raises itself and how guaranteed the money that it gets from Scottish central Government is. The markets and whoever was borrowing would have a view on reliability.

Those things are fairly subjective. I think that we will get to a political solution in that area in particular, but I have no idea what that will be.

John Mason: Can we leave local government aside for the time being and concentrate on what powers the Scottish Parliament can have, or do we need to think about local government at the same time?

Jim Cuthbert: I would have thought that you would need to look at local government at the same time. The Scottish Government controls a large part of the budget for local authorities and

borrowing in Scotland is secured on Scottish tax resources, so it is basically secured on income tax, non-domestic rates and council tax, plus the smaller ones. Given the commonality in the budget-setting process and given that the whole thing will have to be funded out of those three resources, I would have thought that you would have to take an overview of the overall borrowing capacity.

11:30

John McLaren: In terms of local government, there is a bigger issue. Smith was there to decide a change in responsibilities between the central UK Government and the Scottish Government. That begs the question whether a similar conversation should be going on about the relationship that should exist between local government and central Government in Scotland, particularly given the fact that non-domestic rates are fairly centrally set and that council tax is impinged upon, which does not leave an awful lot for local government. Perhaps the next step after Smith is to have a Smith commission within Scotland to see what the public want and what economic rationale there is for the best split between local and central.

John Mason: Jean Urquhart touched on that as well. Smith does not prevent either the Scottish Parliament or a local authority from starting a completely new tax. Is that your understanding?

John McLaren: I think that it allows them that power. It also allows them the power to increase any benefits, including UK benefits, or to introduce new benefits, so it is pretty wide ranging in that sense. I do not know how widely understood that is in Scotland as a whole, but technically there are a lot of powers. There are some constraints that make it difficult for those powers to be used, but the powers are technically there.

John Mason: The final area that I wanted to touch on is the Scottish Fiscal Commission, which both witnesses have mentioned, and the question of how much of a resource we need. The commission is looking at only two small taxes at the moment, but we got the impression from witnesses that they are under pressure and are having to put in quite a lot of time. How quickly do we need to beef up the commission for the negotiation process that you suggested?

John McLaren: As soon as possible. You need experienced people in those positions, not just new people whom you can train up. You need people who have experience of the data that they will be using and of how to understand and analyse it, and there are not many of them in Scotland. That is the case on the urgent side. On the other side, something that cannot be done

quickly is to get a good economic model of the Scottish economy, because the data just is not there. Where it exists, the quality is probably not good, so it will take time—possibly quite a lot of time—to develop.

There are two parts to the model. There is the economic model itself, and then there is the tax side of the model, which tends to be quite big in the UK. The tax side will be easier to develop, but the economic impact on those taxes and the relationships between the two will be tricky and will take time to build on.

Jim Cuthbert: I want to mention another area to which I think attention needs to be paid. We have not discussed VAT, but that will be significant. Scotland has no control over VAT but will be getting about half the VAT revenues, and yet the apportionment of VAT revenues is based upon the household survey data for the UK as a whole. In other words, it is based upon an estimation procedure. Maybe as a result of that, Scotland's historic share of VAT revenues has been fairly volatile, so a lot of attention needs to be paid to putting those estimates on a much sounder footing so that we can cope with the potential volatility of VAT. My wife Margaret has been doing some work on that approach recently, and it is quite interesting to see how tenuous the estimation of VAT receipts is at present.

John Mason: The point was raised before about whether VAT would be based purely on the final payment by the consumer or whether we would also get a share of VAT all the way through. My feeling was that, if a factory is making a lot of products, we should get part of that VAT, even if the products are exported. Is that an issue?

Jim Cuthbert: There are issues there. The present methodology is based on final payments, but there are issues to be explored. The share data involved is estimate based and potentially not very good.

Mark McDonald: As someone who also sits on the Devolution (Further Powers) Committee, I think that there has been something of a disconnect—certainly around benefits—between what was envisaged by Smith and what appears in the command paper, but that is perhaps a discussion for another day.

I want to touch on the no-detriment principle, which has been mentioned a few times. At the Devolution (Further Powers) Committee, it would seem that you can pick your definition of no detriment and where the principle is intended to apply. What is your understanding of what is envisaged by no detriment in general terms and how ought it to apply to the powers under taxation that are coming?

Jim Cuthbert: I regard the no-detriment principle as a recognition of the gearing problem, which Smith recognised, which is that if you allow changes in income tax to affect reserved services, you are in all sorts of trouble and you have to stop that somehow. John McLaren summed it up very well by saying that it was as if the Smith commission were in favour of peace and it brought forward a no-detriment principle in general terms, which was fine and would solve the problem, but did not say how it would be implemented. The detail of what you have in command paper 8990 is a particularly inappropriate way of implementing it. The problem is that I do not see a way of solving the gearing problem without fundamental change. As I said, the federal argument would solve it, but that is not where we are unfortunately. There is, in other words, a fundamental problem with this.

John McLaren: The basic adjustment for changing the income tax in the rest of the UK and Scotland was the main area where no detriment should apply—that is where the big money will be involved. There is then the smaller issue about whether, if you change one benefit here or a little policy there—such as the airport example—that should have a knock-on effect. The answer to that is yes, but or maybe—it is less clear. In the first example there is a clear detriment or gain that has to be adjusted for. In the second example, it is less clear. The third category is the second-round impacts, which we discussed before, whereby changing something on income tax might have a knock-on effect on VAT or something else, and you adjust for those. I do not think that that was addressed at all in Smith, from what I have seen, so I guess that it is up for grabs or up for negotiation.

Mark McDonald: One of the points that Professor Heald raised was around the possibility of gaming. There is the potential, for example, for a decision to be taken at Westminster to dramatically reduce income tax but to compensate for or offset that with a VAT rise. Although there is hypothecation of VAT, only the first 50 per cent of VAT would be unaffected by a rise. However, the income tax variations that would exist across the border might reduce Scotland's ability to react to that. Do you see that as a real risk, or is it simply hypothetical?

John McLaren: I do not think that there will be intentional gaming of that degree, because it is extreme and it would put other things out of kilter. To be honest, I do not think that the rest of the UK Government will be bothering that much about Scotland that it will spend that much time on it. However, there will be unintentional impacts. Say at the next election that somebody decides to have a supertax above the 50 per cent, such as a 70 per cent tax. That would change things. Alternatively, they might decide to change the

allowances and the level at which no tax is paid. Those things could have knock-on impacts, which could mean that it is difficult to work out exactly what is no detriment. I do not think that that is gaming, but what Professor Heald talked about could happen in the normal scheme of things.

Jim Cuthbert: I would be more pessimistic—I think that there is a real possibility that certain Westminster Governments would set out to game the system if they could. It is interesting to refer back to the future of England survey, the results from which were published just before the referendum. The headline was, more or less, “English desire to punish Scots whatever the outcome of the referendum.” We have issues with the future of England survey and the unfortunate leading question that was asked that led to that result; nevertheless, there is a wide perception of a desire to punish Scots and to reduce levels of public expenditure in Scotland to the UK average. I do not think that it takes too much imagination to envisage a Conservative-UK Independence Party coalition at Westminster setting out precisely to exploit the features of the system to achieve such a result, so I think that gaming is a real possibility.

Mark McDonald: On the issue of benefit detriment, if decisions were taken in Scotland in the post-Smith environment that resulted in increased economic activity, a benefit would accrue through an increase in the income tax take, but at the same time benefits would accrue at RUK level—for example, there would be a reduction in the requirement for jobseekers allowance payments through the Department for Work and Pensions and an increase in national insurance contributions, which I think I am right in saying would not flow to Scotland but would remain at UK level.

On paper, we appear to be talking about a fairly simple scenario—more people in jobs equals more tax—but there are more factors involved. How do you envisage that being worked out in a post-Smith environment?

Jim Cuthbert: In those circumstances, everyone should just say, “Hooray!” I do not think that there should be any question of trying to compensate for that. In such a situation, we would be in a well-functioning monetary union in which we would be doing better through income tax as a result of the economy doing well, while Westminster would be benefiting through national insurance, VAT receipts, corporation tax and so on. Everyone would say that that was how the system was meant to work.

The danger is that the system does not work like that and Scotland gets locked into a cycle of relative decline, for the reasons that I have set out.

John McLaren: In the first example that you gave, whereby benefit payments went down in the rest of the UK as a result of a successful policy in Scotland, I think that there is an intention to adjust for that so that Scotland would get some of that money back. I do not think that that is 100 per cent understood, but I gave evidence to the Scottish Affairs Committee on the Smith proposals along with David Phillips from the IFS and that was his opinion. That seemed to be the view that appeared in the final report, and I guess that the Scottish Affairs Committee checked it with other people. Therefore, that is one area in which there might be a no-detriment impact. Regardless of whether it is right or wrong, I think that there might be an intention to make such an adjustment. That would be difficult to calculate.

As far as the other taxes are concerned, higher sales taxes and higher levels of VAT and national insurance that were caused by higher growth would stay at the UK level.

Mark McDonald: I want to get something else clear in my mind. There has been discussion about how the money from the levying of taxes is allocated. For example, how the proceeds of the proposed 50p tax rate could be spent has been discussed. It has been suggested that application of the 50p tax rate in London could lead to revenue flowing to Scotland. It has been mentioned that £250 million could flow to the national health service in Scotland as a result of the implementation of that tax rate, but that, as the number of higher-rate taxpayers in Scotland would not be sufficient to generate that money in Scotland, it would have to be apportioned from elsewhere. Barnett consequentials would not seem to generate that level of revenue.

Is there a post-Smith scenario in which a 50p rate would apply in Scotland and in the rest of the UK and in which that hypothecation of revenue would still take place? I hope that I have explained that clearly enough.

John McLaren: Earlier, I mentioned the prospect of mind-melt questions. I think that my mind has just partially melted.

11:45

Jim Cuthbert: I think that my mind melted a bit as well, but it was groping towards the point that this needs to be modelled. Barnett consequentials will flow, but they will be heavily modified by the abatement and by whatever form of Holtham indexation we have, so there will be pluses and minuses and, potentially, different economic trajectories in different parts of the UK.

Before we can understand the balance of what is to happen, we need some proper modelling of all the effects. We are rather groping towards the

new system, which will have fairly profound effects, without having done that modelling. If it was not done in the seven-week period, it is the sort of study that should have been done; some scenarios should have been worked out.

John McLaren: I very much agree. By working out scenarios and seeing what the impacts are, we can determine whether the outcomes are fair and negotiate on that basis, which will mean that agreed mechanisms can be put in place that will not lead to an argument and will be more likely to lead to what was assumed in advance. However, as Jim Cuthbert said, I do not think that anybody is doing that. If anyone is doing it, it is just the OBR, because no Scottish organisation is set up to pitch in its bit, but I suspect that it is not being done at all. The committee and the Scottish Parliament in general will want to see that work before a final mechanism is signed up to. That applies not just to income tax but to a variety of areas.

The Convener: That concludes questions from other committee members, but I have one or two on the Scottish Fiscal Commission. What progress is being made on the ability to acquire the macroeconomic data that is required for some of the discussions that are happening in Scotland?

John McLaren: We are in a pretty low position when it comes to getting an economic model for Scotland. Even on something such as gross domestic product—what the economy produces as a whole—constant price GDP, including a share of North Sea oil, would be a terrible measure for Scotland, although everybody uses it to measure their economic performance. That is because North Sea oil would make the figures completely irrelevant, as it is the cash price of North Sea oil that counts, not the constant price. That is just one example, and we have produced papers on it. If we are trying to understand Scotland, even though the North Sea element is not in the proposals, it still has to be part of the understanding of the Scottish economy. There is also a lot of foreign ownership, which could impact on things such as income tax.

We need other measures to try to understand the position, but we do not have any. We have a poor understanding of the current account balance of payments, although we have some understanding of trade. Those are just some of the basic building blocks. I imagine that the data on things such as capital investment is pretty poor as well.

It is a big job. As well as having to start collecting the data, we have to collect it for a long period before we can work out trends and patterns in it. It will be more than a decade before we have a model that works well. It is perhaps not so difficult to work out what the impact of different taxes might be although, if Scotland's behaviour

on tax alterations is different from the UK's, Scotland will have to work that out for itself, which again takes time.

It is a big task and we are not in a good place to start with, which just means that we should start all the quicker. Initially, we will have to make shortcuts in trying to work that out.

Jim Cuthbert: I will comment on GERS, which is a slightly different aspect. The GERS exercise has been running for many years and a lot of improvements have been made to it, particularly on the expenditure side. However, even the expenditure side of GERS is by no means perfect. If we look into the details, we find that the same apportionment factors are used by Whitehall departments in apportioning expenditure to Scotland. Therefore, despite the improvements, we cannot even be confident that the expenditure side of GERS is good.

Suddenly, the revenue side of GERS has become very important. The changes that are taking place to collect the Scottish rate of income tax will probably lead to an improvement in the data. However, as I have mentioned, we have an apportionment of VAT based on sample data. That is suddenly going to become very important. However, I suspect that the data is not up to the weight that it is being asked to carry. As the situation evolves, other weaknesses in the apportionment of revenues will come to the fore. Therefore, it is important to put improvements in train there, if the new system is to be soundly based.

John McLaren: I have a little addendum. Corporation tax is one of the big tax measures that we are very unclear about, because we do not have a good understanding of where that would end up were Scotland fiscally autonomous. Corporation tax is not included in the Smith proposal. Perhaps it should have been, or perhaps not. That power is devolved in Northern Ireland, so the impact on Scotland of any change as a result of what it does must be modelled. That all goes back to the asymmetry of the devolution of powers, and the matter becomes complicated.

The Convener: I take on board what you say. On GERS, I understand that £3 billion is apportioned to Scotland for defence but less than £2 billion is spent here.

Given what you have said and the lack of an adequate macroeconomic model, what should the Scottish Fiscal Commission's responsibilities be as it grows, if you like, and becomes more established?

John McLaren: Looking at the example of the OBR is a good place to start. The OBR has followed that process, so there is quite a lot of experience that a Scottish OBR could draw on.

That does not mean that the Scottish OBR would use the OBR's figures; rather, it is about how the model would be set up and would work. That would also depend on the final mechanisms for negotiating no detriment and other such matters. However, were there to be a Scottish OBR and a rest-of-the-UK OBR, the closer they were in what they did, the easier it would be for them to compare data and analysis and negotiate between themselves. That, at least, is a good starting point.

It is more difficult to work out what an enhanced Scottish finance department should look like because, obviously, we do not have a lot of the macro powers. Nevertheless, such a department would need to be beefed up considerably.

Jim Cuthbert: I differ slightly on the relationship with the OBR. The referendum campaign was interesting. The tendency on the part of people such as the Institute for Fiscal Studies was to split the latest OBR projection of the UK economy down to the Scotland level and look at the risks associated with the Scottish forecast. That led to an asymmetry in the handling of risk in the referendum campaign. If all that we are doing is tagging along behind the OBR and looking at a breakdown to Scotland of the OBR projection, we are missing from the debate important aspects in relation to risk, because the OBR does not handle risk properly.

If there are to be closer links with the OBR, they should be used to influence it, so that we take a more informed view of risk. This is a relevant issue. In the general election campaign, certain parties are putting forward policies based on not needing to cut the deficit as fast as the coalition is arguing that it should be cut. Those arguments seem to be correct, provided that we assume that the OBR's relatively optimistic forecast about the UK economy comes true. However, if the risks surrounding the UK economy are factored in, the argument that the deficit does not need to be reduced so quickly becomes a slightly riskier strategy.

The debate is conditioned around what the OBR produces, which does not adequately handle UK risk. It would be a pity just to tag on to that and to continue that mistake.

The Convener: Thank you very much, gentlemen. The session has been interesting. Do you have any further points to make before we conclude?

Jim Cuthbert: We have discussed the no-detriment principle at length, but there is an aspect that we have not discussed. If the adjustments in paragraph 2.4.14 of the command paper are to be made, difficult issues will arise in indexing them. If they are not to be made and the issue is swept under the carpet, the issue does not arise.

However, if the adjustments are to be made, they will have to be indexed somehow. It would be dangerous to let the Treasury say, "We will sweep all the adjustments and abatements together and we'll do it by Holtham indexation," or something like that. As I pointed out in my submission, Holtham indexation would, for the adjustments set out in paragraph 2.4.14, probably be totally inappropriate.

John McLaren: As we have seen, the matter is complex. Despite the convener's experience in the pub last night, the issue is not being debated, and it is certainly not understood outside. When the final solution comes, I do not know how much of a surprise it will be to the Scottish public. Some way to get across what is involved and to get feedback on whether that is what people want would be beneficial. I am not quite sure how that would be done.

We have had the referendum and we have had Smith. Now we must give people something that they may not understand or want—or that they may want but not exactly in the form given. Increased interaction with the public would be good.

The Convener: That is a point well made. On that note, I end the session and thank the witnesses for their contributions.

As the start of the meeting, we agreed to take in private items 4 and 5. I therefore close the public part of the meeting.

11:56

Meeting continued in private until 12:05.

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

Available in e-format only. Printed Scottish Parliament documentation is published in Edinburgh by APS Group Scotland.

All documents are available on
the Scottish Parliament website at:

www.scottish.parliament.uk

For details of documents available to
order in hard copy format, please contact:
APS Scottish Parliament Publications on 0131 629 9941.

For information on the Scottish Parliament contact
Public Information on:

Telephone: 0131 348 5000
Textphone: 0800 092 7100
Email: sp.info@scottish.parliament.uk

e-format first available
ISBN 978-1-78568-403-6

Revised e-format available
ISBN 978-1-78568-417-3