



The Scottish Parliament  
Pàrlamaid na h-Alba

## Official Report

### FINANCE COMMITTEE

Wednesday 29 April 2015



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**FINANCE COMMITTEE**  
**13<sup>th</sup> 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:**

Dr Angus Armstrong (National Institute of Economic and Social Research)

Professor Charlie Jeffery (University of Edinburgh)

Professor Nicola McEwen (Centre on Constitutional Change)

**CLERK TO THE COMMITTEE**

James Johnston

**LOCATION**

The Sir Alexander Fleming Room (CR3)



# Scottish Parliament

## Finance Committee

Wednesday 29 April 2015

*[The Convener opened the meeting at 10:01]*

### Fiscal Framework

**The Convener (Kenneth Gibson):** Good morning and welcome, everyone, to the 13th meeting in 2015 of the Finance Committee. I remind all present to turn off any mobile phones or other electronic devices.

We have received apologies once again from Richard Baker. We look forward to him being back at the committee in a fortnight.

We have only one item of business today, which is to continue taking evidence as part of our inquiry into Scotland's fiscal framework. I welcome to the meeting Dr Angus Armstrong, Professor Charlie Jeffery and Professor Nicola McEwen. Good morning to you all.

Members have received papers from each of our witnesses, so we will go straight to questions. I will start with Professor McEwen's submission. First, I should say that when I ask a question of any panel member, the other panellists should feel free to come in subsequently with their own comments, so that everyone has an equal opportunity to comment, if they want to, on other papers.

Professor McEwen, in the introduction to your submission, you say:

"Managing the new fiscal framework will require more effective and institutionalised intergovernmental relations than currently exist."

In paragraph 1.6, you say:

"Both the Smith Report and the UK Government Command Paper recognise the need for intergovernmental collaboration toward agreement on a new Scottish fiscal framework, consistent with the UK fiscal framework. This would include, among other things, agreements on ... Block Grant Adjustment to reflect new tax-raising powers and welfare responsibilities 'to reflect tax revenues foregone ... and spending no longer undertaken by the UK Government'".

You also talk about how the intergovernmental machinery needs to be scaled up.

Will you talk us through some of that a wee bit more? What are the pitfalls? How can we take the matter forward successfully?

**Professor Nicola McEwen (Centre on Constitutional Change):** There are two things to bear in mind. The first is the machinery for co-

operation and co-ordination between the two Governments, which, at the moment, is quite ad hoc, with a mixture of multilateral forums, such as the joint ministerial committee, and bilateral forums, such as the joint Exchequer committee and the finance quadrilaterals. It is not altogether clear what purpose those serve, beyond sharing information and communicating what each level of Government is doing. They certainly do not make decisions.

The joint Exchequer committee is a little bit different, because it seemed to be set up with the purpose of managing the transition of new powers emerging from the Scotland Act 2012. However, its remit was never agreed between the two Governments—there was a little bit of a difference of opinion on what longer-term purpose it should serve.

The machinery is all very informal and ad hoc. The meetings are not all that regular—for example, we know that the joint Exchequer committee has not met for the past couple of years. Lots of things get taken over at official level. Although the interactions between officials are very important, more regular ministerial interaction would help to serve all the other interactions. As we move towards a more complicated and complex devolution settlement, the gaps, problems and weaknesses in intergovernmental co-operation become more problematic.

The second point is an issue for Parliament. It is clear that there is a lack of reporting of and accountability for intergovernmental relations. As the forums become more important, the role of Parliament in scrutinising both what they do and relations between Governments becomes more pressing. There is a problem regarding the relations themselves, accountability for them and scrutiny that needs to be addressed.

**The Convener:** Okay. You are saying that much more formal arrangements should exist.

**Professor McEwen:** The arrangements should be more formal and more transparent.

**The Convener:** The Scottish Parliament information centre's briefing for the committee, which you may or may not have seen, quotes the *Official Report* of a Finance Committee meeting at which John Swinney spoke about the block grant adjustment. You will be familiar with what was said, but I will read it out for the record. Mr Swinney stated:

"there were two and a half years of evidence gathering, different discussions, different research processes and so on, but it was sorted out in a 15-minute conversation between the Chief Secretary to the Treasury and me",

which shows that

"if there is a will and a necessity to agree these issues, they can be agreed within a reasonable timescale."—[*Official Report, Finance Committee*, 28 January 2015; c 38.]

As the SPICe paper comments, and as you have already mentioned, that

"raises questions around transparency of decision making".

The Finance Committee took evidence from the Chief Secretary to the Treasury, John Swinney, David Gauke from the Treasury and various other people and organisations, but at the end of the day the matter was sorted out in a telephone call. That is clearly no way to resolve things—obviously, it had to be done at the very last minute because of a lack of agreement and because we had a budget to pass. However, you are saying that you would like to see more formal mechanisms by which such matters are resolved, given that the block grant adjustment was only for one year and we will have to go through the process again.

**Professor McEwen:** You referred to a 15-minute conversation, which I understand was a conversation about one Government's figure and the other Government's figure, and they split the difference. I know that politics sometimes works that way, but, looking forward, you might like to have a more systematic way of working those things out.

The committee secured a concession that potentially sets a precedent, in the form of the papers that you received from the meetings of the joint Exchequer committee. There is nothing like that in relation to the joint ministerial committee or any other intergovernmental forum.

As the joint Exchequer committee had not met for a couple of years, the information was clearly not altogether satisfactory, but the minutes of the meetings that you received were very frank—I was surprised when I read them to see how frank they were. If that sets a precedent for other intergovernmental forums to report to Parliament to allow you to scrutinise those relationships, that would be a positive development.

**The Convener:** Thank you. I will make one further point before I bring in Professor Jeffery.

In your submission, you state:

"The Calman Commission ... recommended that a JMC (Finance) be established, but this was not pursued."

Is that something that you believe should be pursued?

**Professor McEwen:** Possibly. I am not quite sure why that recommendation was not pursued, and why the Governments decided that there was no need for such a committee. Finance issues come under the remit of the joint ministerial committee on domestic affairs, but as tax

devolution intensifies there might be a case for having a dedicated forum in which to discuss purely those issues.

The downside is that, because of the asymmetry in devolution throughout the UK, the joint ministerial committee is for all the devolved Administrations and the UK Government, so it might not be the most appropriate forum as we move forward.

**The Convener:** Okay—thank you for that. I will bring in Professor Jeffery now.

**Professor Charlie Jeffery (University of Edinburgh):** Thank you. I am fully in line with Professor McEwen's comments about the need for more systematic relationships between Governments and for opportunities for greater scrutiny to be available to Parliaments with regard to what Governments do. I also note that I have been saying that for 15 years, ever since the devolution reforms in their first incarnation were implemented.

Academic expertise has contributed to various inquiries by various parliamentary committees in the UK, Scottish, Welsh and Northern Irish contexts by making that suggestion. The current situation probably speaks a little bit to our failure as academics to have our expertise make the impact that we would like it to make, but it also says something about the UK state and the approach that its central institutions have taken to what we might call territorial management. The UK state has not adapted during that period to the realities of devolution, which include a more explicit need to think across the various legitimately constituted Governments of the UK, and to find common purpose and mutually acceptable arrangements.

In the absence of those things, we have a set of ever-evolving bilateral arrangements between the UK and Scotland, the UK and Wales and the UK and Northern Ireland. There is no particular system around those arrangements, and in some respects there is a fragmentary tendency.

In my submission to the committee, I point to the continuation of that tendency, with parallel reforms under way or under discussion in Scotland, Wales and Northern Ireland, and a political context that, at present and no doubt for some time to come, is quite likely to add further ad hoc bilateral adjustments to that system in the various places. That renders the system as a whole increasingly non-transparent and increasingly difficult to capture in a systematic structure of intergovernmental relations. There is a syndrome here that no one appears to be able to get a grip on.

**The Convener:** Okay—thank you for that. I will bring in Dr Armstrong now.

**Dr Angus Armstrong (National Institute of Economic and Social Research):** Good morning. First, I would like to make it clear for the record that I stood for nomination as a candidate for the Labour Party in Edinburgh South West in January. Since the end of January—I think that the hustings were on 30 or 31 January—I have had no political involvement.

**The Convener:** We knew that—you dodged a bullet there.

**Dr Armstrong:** I just wanted to be clear about that.

I have very little to add to what my colleagues have said. With regard to the machinery, I point out only that the classic principle of federalism as outlined by Wallace Oates refers a great deal to spillovers. Where spillovers are minimised, it is much easier to devolve powers. Between two—in fact, four—such integrated countries, there will be a considerable number of spillovers, and that supports the need to have as formal a structure as possible to measure and make adjustments for those spillovers.

**The Convener:** Thank you for that, Dr Armstrong. In your submission, you refer a great deal to borrowing, and state that Scotland

“should be free to borrow ... under its own name from ... capital markets.”

However, you then go on to discuss the subject of spillovers, which you have just mentioned. You note that

“One of the most important and long lasting spill-overs from decentralising fiscal powers is fiscal indiscipline at sub-central government affecting the credit worthiness of central government.”

Is there any evidence that there has been any fiscal indiscipline in Scotland?

**Dr Armstrong:** The question is really about what would happen in light of the Smith proposals. At present, it is a hypothetical question, because the revenue powers that are about to be devolved will be significantly different from what has been in place.

I am in no way saying that there has been indiscipline in the past; I am merely trying to point out that, where powers have been devolved in federal structures around the world, one of the most difficult issues that countries have had to deal with is the recurring problem of fiscal indiscipline because responsibility and liability are not fully aligned. The comments in my submission are much more of a summary of the evidence from countries around the world over the past 400 years. They are not supposed to reflect what has happened in the past in Scotland—indeed, Scotland has not even issued any bonds yet.

I would say that in the debate there has been a real lack of clarity on all sides on that question. It really is a very important question. The command paper seems to suggest something different from what the Smith commission suggests. One can read the command paper's suggestion in two ways, but it appears to go further than the Smith commission does. It is not at all clear what the paragraph in the Smith commission report is supposed to mean, yet it is extremely important to find a lasting and appropriate solution.

10:15

**The Convener:** You say in your submission that “the Commission is utterly vague” on that issue.

**Dr Armstrong:** It is. The paragraph seems to be used just about everywhere by different Assemblies, and it is just not clear what it means.

**The Convener:** Thanks. Let us move on.

There seems to be an assumption throughout your submission—it is a wee bit gloom and doom—that Scotland would run into fiscal difficulties, because there is a lot of talk about bail-outs. You say that

“Scotland's share of public debt (approximately £126bn) would need to be repaid before debt issuance powers are granted.”

How is that achievable?

**Dr Armstrong:** That was in the case of full fiscal autonomy in which all tax revenue goes to the Scottish Government so no tax revenue from Scotland goes to the rest of the UK. The question then becomes, “If there is an issue at some point in the future, what redress would the rest of the UK have?” It would not have any claim to any tax revenues in Scotland. The Smith commission report says that the UK could always introduce a new tax to deal with that. I think that that approach is highly unlikely to be successful, hence the comment in my submission about the Boston tea party. It would be very difficult to do in the circumstances.

If, in relation to such negotiations, a central UK Government accumulated no tax revenue, the question becomes how the rest of the UK would make sure that it would always be protected. One way would be to have no tax liability from Scottish taxpayers to the rest of the UK.

**The Convener:** Surely if that happened, the debt could be assigned to Scotland and the interest or whatever paid? You are not seriously expecting Scotland to pay that debt to the UK. From where would Scotland find £126 billion overnight to write a cheque to the UK?

**Dr Armstrong:** That is the issue of full fiscal autonomy. If no revenue goes to central Government, that is quite a big change from where we are at the moment, where 90 per cent of revenue goes to central Government. If, at the extreme, no Scottish tax revenue goes to central Government, you have to go to the endgame and ask what would happen in the worst possible circumstance, and how that negotiation would work out. In effect, you solve it backwards. The rest of the UK should have no liability on behalf of Scottish taxpayers because it would be getting no revenue from them. An agreement to pay the interest would leave RUK households exposed to the stock of debt that is currently the equivalent responsibility of Scottish taxpayers.

The idea that there would be no liability to RUK if zero tax revenue goes to the RUK Government is a very big departure from where we are today, but it would be the ultimate protection for the rest of the UK.

**The Convener:** Hmm. Professor Jeffery, what is your view on that?

**Professor Jeffery:** When we move into that territory, I step out of my disciplinary expertise. The discipline of economics—a very fine discipline—often works with very clean assumptions from which it tries to draw inferences. How politics—political science—works is altogether much grubbier. My reading of the situation that Angus Armstrong describes is that it would not happen in one go. We have heard from Scottish National Party sources that full financial responsibility—as full fiscal autonomy now seems to be known—would be phased in.

In a sense, that process is under way, with the very limited amount of fiscal autonomy that was established for the Scottish Parliament at the outset being supplemented as the Scotland Act 2012 powers come in. Some variation on the Smith proposals is likely to be pursued by whichever party grouping controls a majority of seats in the UK Parliament after the next election, and there is a commitment by the SNP to press for full financial responsibility on a phasing-in basis. That sounds to me like grubby politics at play, which would not leave us with the kind of cliff-edge assumption that Angus Armstrong has set out. The matter would be negotiated in the context of a changing Scottish fiscal framework amid a changing UK fiscal framework over a period of years.

**Professor McEwen:** I do not have too much to add, as the issue is outside my disciplinary comfort zone, too. However, it is an illustration of the point that increasing fiscal autonomy or any other kind of autonomy heightens the prospect of spillover effects, which Angus Armstrong has referred to. Those effects would be in both

directions, actually. If there are greater responsibilities in Scotland, paradoxically, that could make Scotland more vulnerable to the decisions that are taken elsewhere and which impinge on those responsibilities and, at the same time, it could heighten the potential for Scottish Government decisions to have cross-border effect.

That reinforces the central point that I am trying to make: the more we increase powers in Scotland, the more we need to have agreements and institutions in place to manage the spillover effects. The transition to whatever set of new powers we move to should go hand in hand with agreement on how to manage and co-ordinate the messy edges and the spillover effects.

**The Convener:** I do not want to go too far into the issue of full fiscal autonomy without letting in colleagues, but Dr Armstrong's written submission states that if Scotland were to seek full fiscal autonomy, the UK would have almost no method of redress. Surely the UK holds the whip hand on that. Ultimately, it has control.

**Dr Armstrong:** What do you mean by "control"?

**The Convener:** The UK Government controls the political and economic levers in the UK economy at present, does it not?

**Dr Armstrong:** That would be for the rest of the UK. As far as I understand full fiscal autonomy, the taxation would be collected in Scotland rather than redistributed back through a block grant, and a number of services would be bought in, so to speak, for things such as defence, foreign affairs and, I presume, financial stability.

**The Convener:** I realise that. Sorry, but I probably did not ask the question properly. What I am asking is: if full fiscal autonomy comes in, is it irreversible? That seems to be the implication of what you said in your submission. That is what I am trying to get at. Maybe we are talking about two different issues, but that is what I was trying to get at.

**Dr Armstrong:** Oh—I see what you mean. You are asking whether, if full fiscal autonomy happened, there would be a way that the UK could seek redress if it wanted to take back some of the powers.

**The Convener:** Yes.

**Dr Armstrong:** There is no certainty about that. That is the problem. How would that be done in what presumably would be difficult circumstances?

You said that my submission is gloomy, but it is not a forecast. The point about economics is to look at the worst scenarios to ensure that they are safeguarded against before they happen. If people had done that in Europe and had taken notice of the issues at the beginning, we would not have the



poor architecture that we have. My submission is in no way supposed to be a forecast; it is supposed to set out the parameters within which things would work. It is better to be hard-headed and clear about those at the start. However, I totally acknowledge that, ultimately, there would be a political negotiation—of course there would be.

**The Convener:** I understand that, but the reason why I said that your submission is gloomy is because the Institute for Fiscal Studies takes a slightly different view. On 11 March, it said:

“full fiscal autonomy would give more freedom to pursue different, and perhaps better fiscal policy, and to undertake the radical, politically challenging reforms that could generate additional growth. There are undoubtedly areas where existing UK policy could be improved upon.”

Do you not accept that? There does not seem to be any of that in your submission.

**Dr Armstrong:** I say in my final paragraph that the paper does not look at what could be the growth improving side. If you have control of your taxation and spending, you can do lots of things that may or may not make things better or worse. That would, quite rightly, be entirely for Scotland to decide.

We have made it clear a number of times that Scotland should be free to borrow. We have not said that there should be constraint, because we understand that the idea is that Scotland should have the capacity to manage its own affairs. That can only really happen if it has at least greater capacity to borrow. I argue that it should have the capacity to borrow.

**The Convener:** Before I open up the discussion to colleagues, I want to move on to Professor Jeffery's paper, as I have not touched on it. I always feel that I am stealing everyone else's time when I spend so much time asking questions. I am trying not to overdo it with the witnesses, so I will stay focused on one area.

Professor Jeffery, you say in your paper that “Scotland in the United Kingdom: An enduring settlement” is

“unlikely to be a reliable guide for Scotland's future fiscal framework”

and you point out the reasons for that. Will you expand on those reasons for the record and on some of the other issues that you believe could create a shift in what Smith came out with?

Will you also touch on the Barnett formula? You say that

“Barnett begins to wither on the vine”

once some of the changes are made.

**Professor Jeffery:** Scotland's fiscal framework exists within a UK fiscal framework and the two

relate to each other. It might well be said that there are also Welsh and Northern Irish fiscal frameworks, and quite possibly an emerging English one. They are all moving parts in a system, and they are each moving in different ways for different reasons, three of which I set out in my paper.

The first reason is that the Smith commission consensus is no longer a consensus on what was written in the Smith report. In my paper, I said that John Swinney moved away from that at the press conference that marked the launch of the report. He said, “Okay, we'll take this, but we think there should be more in various ways and for various reasons.”

The Labour Party has supplemented rather vaguely what it thinks a new Scotland bill should offer in the field of welfare, and the Conservative Party has taken away the Smith commission commitment that all UK MPs should vote on any budget decisions to do with income tax. That is now gone from the Conservative Party vision, as set out by William Hague in January and reiterated in an English manifesto, a written version of which I have as yet been unable to track down. Smith is therefore a moving target. At least three of the signatory parties have moved beyond the initial consensus in different ways.

The point about the Barnett formula is a different one. The Barnett formula is a fundamental part of the existing framework for determining the budgets of the devolved Administrations, but it is becoming less important because fiscal autonomy at the devolved level has increased, which means that there is a smaller quantum through which Barnett consequential will flow, and because the Scottish Parliament will have part of the responsibility for fundraising under the Scotland Act 2012 and whatever comes out of the Smith commission. A similar process is under way in Northern Ireland for corporation tax and something similar is envisaged for Wales, as the Silk commission proposals on finance move towards legislation. The Barnett process will therefore become a smaller part of the system and the fiscal autonomy that generates own revenues will become bigger.

10:30

Moving beyond Smith, the Conservative Party has made an interesting suggestion about an English rate of income tax. I am not sure whether that is what it is actually proposing; it is probably proposing to have an English, Welsh and Northern Irish rate of income tax, to be determined by a group of UK Parliament MPs, to the exclusion of Scottish MPs. Whether that is English, or English, Welsh and Northern Irish, is an interesting issue relative to Barnett consequential, because the package of decision making about what happens

in England is what has driven adjustments to devolved budgets through the Barnett process. If you begin to take England as a distinct unit, not subject to decision making by all UK MPs, you move into a very different place.

I am not a fan of the Barnett system at all, but it may make some sense if all UK MPs make decisions about England in the consciousness that it affects the budgets of the devolved Administrations. If a separate decision-making space is created for England, that rationale becomes challenged. If English MPs decide on matters to do with England without the inclusion of MPs from the rest of the UK, it undermines the principles in the system. We are not there yet—that is speculation—but it is a logical consequence of the way in which the Conservative Party has moved.

The final moving part is the UK general election. If the committee was meeting in a month's time, it might be a bit surer of where we are. There is speculation and, to some extent, parties representing distinct bits of the UK have price lists for helping to establish a UK Government of either colour. For example, a price of £1 billion per year has been attributed to the Democratic Unionists in Northern Ireland. That would not be a Barnett payment, because to generate an additional £1 billion for Northern Ireland through Barnett would mean an awful lot of extra spending at UK level. It would be, very explicitly, a deal to bypass the current system.

Plaid Cymru, in Wales, has argued for per capita returns equivalent to those that Scotland receives under the current system. Again, if that were to be generated through Barnett, it would mean a very big boost to UK-level spending, which would of course feed through to Scotland and maintain the differential, so Plaid Cymru means a side payment for Wales, which would be beyond Barnett.

Depending on how the numbers work out, we could see a system in which the mainstay of the UK's system of territorial arrangements for budget adjustments is increasingly bypassed. The system contains all sorts of moving parts, which render the current situation less transparent, more subject to asymmetric relationships between the different parts of the UK, harder to conceive and manage through intergovernmental relations, and much harder for you and your equivalents in the various Parliaments of the UK to oversee and scrutinise adequately.

**Dr Armstrong:** Charlie Jeffery touched on the English votes for English laws issue, which is where the problem of asymmetry of size really raises its head and becomes very difficult to solve. If one was to go down that route—this is hypothetical, because we do not even know what

it would look like—the English committee or Parliament or whatever would make income tax decisions for 85 per cent of the union, which clearly would have spillovers to the other parts of the union. Monetary policy takes into consideration the overall fiscal position of the UK, 85 per cent of which would be decided by the committee, Parliament or whatever. Everybody else would have to live with the monetary policy decision.

That would be quite undemocratic in many ways, so it would also run into problems. As we have pointed out to the Treasury Select Committee, there are real issues of democracy around that because of that interaction between fiscal and monetary policy when it relates to around 85 per cent of the whole union.

**The Convener:** Do you want to comment, Professor McEwen?

**Professor McEwen:** Just briefly. I do not think that the Smith proposals or their translation into the command paper and the draft clauses were “an enduring settlement” anyway. Elements in it would have created new anomalies that would have meant revisiting the issue before too long. An example of that might be the tax powers that we have been discussing. If the UK devolved all income tax on earned income only and the Scottish Parliament chose to raise the higher rate of income tax, it would not be beyond the realms of possibility for higher earners to shift their income into unearned savings or dividends, or to change their residence status, if that option was open to them. That would not have been the intention of devolving the power, but it could be one of those unintended consequences. I think that there are anomalies all the way through that package.

I agree with Charlie Jeffery that the politics is moving on very rapidly, which means uncertainty about what will happen. I think that there have to be a Scotland bill because the politics demands something before next year's election, but the possible contents of that are still unclear.

On the issue of an English, Welsh and Northern Ireland rate of income tax or English votes for English laws, one of the implications of that—I have not seen evidence yet of it being thought through—is that it would demand a change in the way that the UK Government does its business, not just in terms of finance but because it does not think or organise itself on a territorial basis for England only or in a jurisdictional way. That would need to change as one of the consequences of the changes in parliamentary and legislative procedures that would also need a change in government and the executive.

Lots of things are perhaps said in the heat of an election campaign for which the details and consequences remain unclear.

**The Convener:** Thank you for that. I open up the session to colleagues around the table. The first person to ask a question will be the deputy convener, who will be followed by Mark McDonald.

**John Mason (Glasgow Shettleston) (SNP):** Thank you, convener. My colleagues and I will probably go over similar themes in our questions. Transparency has been touched on already, and there was reference to the suggestion that the Democratic Unionist Party might ask for an extra £1 billion for Northern Ireland. In a sense, that is very transparent because we all see it happening and, if it was agreed to, that would also be open. There is no problem with transparency there, although I suppose there might be a lack of logic to it.

On Professor McEwen's example about the block grant adjustment, what happened there was quite transparent, too: we did all the studies for two years, then in 15 minutes John Swinney and the UK Treasury made a decision. I think that both sides have been quite open about that, so it has been quite transparent. Again, however, it might not be totally logical.

Should we really be worried about transparency?

**Professor McEwen:** I will let Charlie Jeffery deal with the DUP issue. The point that I was trying to make is that the level of transparency that you had on the block grant discussions—after pressing for it, I understand—is unusual in intergovernmental relations. I do not know whether any of you have read annual reports of the joint ministerial committee—they are about a page and half of very generously spaced text that barely tells what was on the agenda of meetings, let alone gives the substance of the discussions. The level of detail about the block grant discussions that was made available to members should perhaps serve as a precedent.

I understand the sensitivities within Government when a degree of confidentiality is needed, especially in advance of meetings at which people will maybe not declare their hand publicly because that would be damaging or make it more difficult to gain concessions. However, there is a balance to be struck regarding the degree of transparency about what is forthcoming in those meetings so that Parliament has the opportunity to contribute to that. There is also a balance to be struck particularly regarding the degree of transparency in the aftermath of the meetings so that Parliament has an opportunity to scrutinise and question the Government on the content of discussions. That

does not take place in any other area of intergovernmental relations.

**John Mason:** All the papers that I have seen seem to say that there is a need for a formal structure and for good informal relationships—that seems to be taken as read. Is the problem that we need an informal relationship, then broad agreement, then a structured meeting, and then concrete reasons for why a decision was made? Would that take us forward?

**Professor McEwen:** It would partly do so. Officials would probably suggest that things only get as far as a formal ministerial meeting if they cannot be resolved through the more informal channels. That is normal and common in other systems.

However, it is appropriate that Parliament has an opportunity for scrutiny when there are politically contentious issues or jurisdictional issues. If such issues cannot be dealt with through the informal channels, they might make it to that sort of forum—and maybe members should know about that. Perhaps members should know the rationale for conclusions when decisions are made.

One thing that I would say on the joint ministerial committee and formalisation is that, although formalisation is important, it has to go alongside a revision to what the forum is for and a reflection on the purpose of such forums. If they are regular and institutionalised, and they meet and do not do much, it is not in the interests of any Government to invest time and resources in them. If the forum is focused and has a clear purpose, which might mean making decisions—which joint ministerial committees do not do at the moment because they are not executive bodies—that would probably be positive, but it would require agreement from all parties on the forum's purpose and their status within it. At the moment, the JMC has a joint secretariat, but it functions in a bit of a hierarchical way, which one can see could be problematic for the devolved Governments.

**John Mason:** The SPICe paper refers to other countries—sometimes using your comments. I am not sure whether you are an expert on this, but are there good models out there? I get the impression that in Germany and Canada there are constant meetings. Do they work, or are they just formalities?

**Professor McEwen:** It is probably a bit of both. Charlie Jeffery mentioned earlier the plethora of bilateral arrangements that are emerging between the Governments in different bits of the UK. However, there is still very little here compared with intergovernmental relations in most other countries that I am aware of, where there are many more forums for discussion. Some forums

are more important than others; it depends on the differences between the Governments, or on the personalities involved.

The SPICe paper points out three things that are important to bear in mind. First, the UK is not a federation; secondly, the UK is incredibly asymmetric; and thirdly, it is a multinational state. Those things affect the dynamic of intergovernmental relations; that is not the case in Germany, although it is maybe a little more so in Canada.

**Professor Jeffery:** I might say something about Germany, but first I want to come back to the point about the DUP. I think that there is more to transparency than saying, "This is what we want, and that is our price." One might ask where the figure of £1 billion came from. Where is the evidence-based process that produced that figure, and when was it debated in the Northern Ireland Assembly? I think that you would find that the answers to those questions are, "It wasn't debated; that's what we made up, because that's what we thought we might be able to get, if the numbers turn out that way."

Transparency is about predictability and having rules of the game so that scrutiny can be done on a systematic basis. It is worth reflecting that the Barnett formula was introduced to produce a certain level of stability in the rules of the game, in a sense. Before that, funding by the UK Government of Scotland, Wales and Northern Ireland depended on the negotiating skills of the Secretary of State for Scotland and others in discussions with the UK Treasury. That was felt not to be terribly transparent and not to be the best basis for establishing territorial funding flows. What we are seeing now is a calculation about what kind of leverage can come from an election rather than a clearly established set of rules of the game that are amenable to debate and scrutiny.

10:45

**John Mason:** On that point, is one better than the other? You say that there used to be just a negotiation, whereas now we have a more mechanical system—a previous witness used the word "mechanical". Is one way of doing things inherently better than the other, or are we just talking about two different ways of doing things?

**Professor Jeffery:** Territorial finance in decentralised states is always a mix of the two. There are always calculations of power, however that is defined. It can be the economic power that a particular unit has or it can be the outcome of an election, which can temporarily invest power in a party—the DUP—that will have, at best, nine MPs. That will always be part of the process.

Given the way in which the UK is trying to adapt to meet various pressures for additional decentralisation, a clearer understanding of how territorial finance decisions are made would be quite helpful for the stability of the arrangements in each part of the UK, and for the stability of their operation from year to year. That is what rules of the game—broadly agreed principles around which a political negotiation takes place—deliver.

They have that in spades in Germany, where there is a more or less constant process of negotiation among the territorial units and between them collectively and the central level. I do not think that that is a suitable model for the UK, because in many senses Germany is a very centralised country that draws the territorial units into government at the centre. To a considerable extent, Germany has established its rules of the game in the country's constitution, so they have a very high legal status. As a country that is unable to write down its constitution in one place, we are some way from finding ourselves in that position.

**Dr Armstrong:** I simply point out that a large number of meetings does not equal transparency. Opacity and a lack of transparency are necessary conditions for moral hazard. Moral hazard does not come out of thin air—it arises when things are opaque and not clear. That is when we get risk shifting, and that is why we want to get rid of it. As Charlie Jeffery said, the best way of doing that is by having the rules set as clearly as possible right at the beginning.

**John Mason:** In your submission, you spend quite a lot of time on debt and the relationship between Scottish debt and UK debt. An issue that has been brought up with us previously is the relationship with local government debt. Is that a factor? As we move forward, do we need to consider how we deal with local government debt, given that local government largely does its own thing under the prudential framework?

**Dr Armstrong:** I think that there is an issue that applies to the whole UK. We need much greater oversight of local authority debt and of local authority off-balance-sheet financing. In the past, there was considerable leeway for local authorities to enter long-term agreements on which there was a lack of clarity, and whose implications were not clear, if the situation on interest rates had turned out different over the past 10 years. I understand that most such agreements have been unwound, but it struck me that the only people who gained from them were the investment banks that advised local authorities. It was not at all clear what risks the authorities were taking on. There is a broader issue that needs to be considered.

**John Mason:** The argument for the prudential framework is that as long as the individual unit can afford to repay whatever it is committed to, be it a

straight debt or some other arrangement, things should be okay. Do you argue that the centre should be more worried about the constituent parts?

**Dr Armstrong:** Yes. You could say that under a prudential framework—which is an interesting term—it is okay as long as you can pay the debt, and it is only when you cannot pay the debt that it becomes an issue. We must consider what would happen if it could not be paid and what the incentives would be for another part of Government to step in and resolve the matter. Responsibility and liability need to be aligned in order to have authority and responsible governance. It must from the beginning be understood what would happen if things were not to turn out as a local authority had envisaged.

It is very important to establish the rules as clearly as possible. The lesson from many federal Governments seems to be that there is an on-going difficulty with being clear in that regard, partly because of how the federations evolved. They are all very different—each country's federation has a different structure and nature because of the country's political history. As an economist, I think that being as clear as possible about where liability lies is a first-order item.

**John Mason:** If a Scottish local authority got into trouble, the Scottish Parliament would have to go in and sort it out, would it not? Similarly, if the Scottish Parliament got into trouble, the UK would have to step in.

**Dr Armstrong:** Obviously, that would be your decision to make. I expect that under the current arrangements the next level of government would come in and support any UK local authority that got into trouble—not least because, as Alexander Hamilton said, you should have borrowing powers only if you have a means of extinguishing the debt. If it does not have revenue-raising powers, giving a body borrowing powers is not very prudent, because there would be no way that it could resolve the situation itself if it got into trouble. Of course, full fiscal autonomy would be very different, because all fiscal powers would be awarded to the Scottish Government.

On transparency and borrowing, is the intention—it is accepted that forecasting errors happen—that a Scottish Government will forever run a balanced budget? If that is the intention, you would in effect be casting aside the last 90 years of economic development saying that you can smooth shocks. If you then say that you are able to have a separate macroeconomic policy, that would seem to contradict what the UK has said in the command paper. That is what I mean by a lack of transparency. There seems to be no understanding of what each other's position is.

**John Mason:** Would bringing in a third party help? In Australia there has been talk about the Commonwealth Grants Commission. I am not sure how members are appointed to it, but they seem to be able to stand outside the Government relationships. Is that a good model?

**Dr Armstrong:** As far as I understand it, the CFC gets involved when provinces need additional support.

We are very much at the inception stage and talking about how we set up the rules and the responsibilities in the legislation. That is for national Parliaments and politicians to solve. The difficulty is that it is not exactly clear what each Government has in mind when it comes to issues such as debt. The paragraph in the Smith commission report that I have cited is quite often used—in various guises, with a few words changed—in relation to the overall UK fiscal framework. Would it change every time the UK fiscal framework changes?

**John Mason:** That is a good question. Thank you.

Professor McEwen mentioned the no-detriment principle, which has come up at committee quite a lot. You analyse the different levels clearly—you talk about a relaxed no-detriment level and a strict no-detriment level. Has that worked in other countries, specifically in relation to whether it can be on-going? We have had conflicting evidence about whether we can have no detriment on an on-going basis.

**Professor McEwen:** I am not aware of anything that exactly resembles a strict interpretation of “no detriment” as it is set out in the Smith commission report. My knowledge is a little bit sketchy, but there are agreements elsewhere. In Belgium, for example, additional fiscal autonomy went alongside co-operation agreements that would minimise tax competition between the regions in the country, which is kind of like no detriment on an on-going basis. Charlie Jeffery might have something to say about Germany, because a solidarity principle is in place there, but I think that it is more akin to a bailing-out scenario than to a no-detriment one.

In the countries that I know of, detriment or consequences—spillover effects, if you like—happen routinely. That is one of the consequences of multilevel Government. Within the European Union, we have an element of control around competition policy, which ought to some extent to minimise detriment, but I do not know of anything that goes as far as my interpretation of the second no-detriment clause in the Smith commission report, which would require financial compensation for policy decisions that had a detrimental impact. I cannot for the life of me see how that would be

manageable in a way that was not highly politically contentious.

**John Mason:** I note that you provided written evidence to the House of Lords Select Committee on the Constitution, in which you stated:

“there is no such thing as ‘watertight compartments’ ... there will be inevitable spillover effects”.

**Professor McEwen:** Yes.

**John Mason:** Do we just have to live with the fact that it is going to be a bit untidy?

**Professor McEwen:** I think that we do. Multilevel Government is untidy.

**John Mason:** Okay. Professor Jeffery—do you want to comment?

**Professor Jeffery:** I want to reflect on an interesting idea that has been put into the election campaign, possibly without much thought. It was very big in *The Cumberland News* recently.

**The Convener:** I must have missed that.

**Professor Jeffery:** I have the press clipping here. There are all sorts of local papers in Cumberland and they were full of the so-called Carlisle principle, which the Prime Minister set out on 21 April. The idea is that a Conservative Government after May would conduct an annual review of the impact of the Scottish Government’s policies, including taxation, to assess whether they have had an adverse impact on other parts of the UK. The Prime Minister said:

“This is about making sure we understand the impact that devolution is having, and make sure that rest of the country never unwittingly loses out.”

I had an exchange with Nicola McEwen about that before the meeting. Unbeknown to each other, I had coined the “Gretna principle” and she had coined the “Dumfries principle”. There is something a bit asymmetric in the assumptions that underlie the Carlisle principle, which is the absence of consideration of UK Government decisions that have a detrimental impact on Scotland. What body would be set up to look at that alongside the annual review of the impact of Scotland on the rest of the UK?

That points a little towards a possible need for an independent arbiter, or at least an arm’s-length arbiter, and a capacity for analysis that is not driven by central Government and can act as judge and jury without being subject to the same accountability requirements for its own decisions and their spillover impacts.

That points to the real difficulty, which Nicola McEwen has emphasised, with enacting the on-going no-detriment principle. It is a very strange understanding and one that does not have many equivalents elsewhere—except in on-going

intergovernmental relationships, in so far as they are institutionalised in other places, which clearly look at the spillover effects. However, if we do not have those on-going intergovernmental relationships organised in a systematic way, we cannot have the mutuality that is needed to understand the spillovers between different jurisdictions.

11:00

**Dr Armstrong:** As an economist, I find the phrase “no detriment” extraordinary. It sounds like a lawyer’s phrase. Although having an independent panel of experts might be the best of a number of bad ways to make estimates, the idea that no detriment can be estimated economically is very optimistic.

The consequences for Scotland seem to be much bigger than for the rest of the UK. Let us take trade between Scotland and the rest of the UK. The sterling amount is obviously exactly the same both ways, because it goes across the same border. Because Scotland is 8.5 per cent of the UK, total trade between Scotland and the rest of the UK, as a share of Scotland’s gross domestic product, is worth about 70 per cent. Therefore, any change in that trade has a huge impact on Scotland. The other way round, the proportion is 7 per cent. A 1 percentage point change in Scottish policy, good or bad, has a fairly small effect on the rest of the UK. A 1 percentage point change in rest-of-UK policy, good or bad, has an enormous effect on Scotland. That asymmetry plays here again, so it is very important to get things right.

In sense that is why, bizarrely enough, you would almost want to have more controls over the rest of the UK than you would want to have on Scotland. Although everybody thinks that it should be the other way round, it is the rest of the UK that could really make life difficult through its good or bad decisions.

**John Mason:** That is a fair point.

**Professor McEwen:** There is not much detail on the Carlisle principle, but my reading of it is perhaps a little different, and this comes alongside the interventions of George Osborne at the Treasury Committee that I cited in our paper. He seemed to interpret “no detriment” as meaning that, if there was a detrimental impact in the north of England, say, it would be the UK Government’s responsibility to intervene to manage that. The Carlisle principle could be read in that way: a commitment by the Conservatives made to the north of England in an election campaign to say that, if there is a detrimental impact, they will step in to address it.

It is not clear whether that evidence of detriment would lead to some sort of intergovernmental

agreement or expectation that the Scottish Government would also step in to alleviate that detrimental impact. That is an altogether different proposition and would be much more problematic. It would have to work in the reverse situation, too, and that would be equally problematic.

**John Mason:** We could probably spend all day discussing this, but that was great—thank you.

**Mark McDonald (Aberdeen Donside) (SNP):** As the convener and the deputy convener have hoovered up most of the questions that I had anticipated asking, this will probably be quite brief.

I would like to go a bit further on the no-detriment stuff. My understanding at the beginning of the whole process was that the no-detriment principle was intended to apply simply at the point at which powers were transferred. It appears to have grown into other definitions, and there appear to be three or four different interpretations now in play, depending on who we are asking and when we are asking them. How far forward is no detriment intended to apply, in your understanding, to how policies are enacted? A no-detriment principle could still be getting applied 20 years into the future. How does that actually take effect?

**Professor McEwen:** Different no-detriment effects are set out in the Smith commission report. The first, which you mentioned, is at the point of devolution, such that neither Government should be any better off or worse off as a result of that transfer of powers, whether it is revenue-raising powers or spending powers. That is not necessarily easy, as you have seen in the case of block grant adjustment debates, but it is doable.

The Smith commission report also stipulates two other areas of no detriment. First, the report says:

“Changes to taxes in the rest of the UK, for which responsibility in Scotland has been devolved, should only affect public spending in the rest of the UK.”

That relates to the tax issues that we have already discussed. Secondly, the report says:

“Where either the UK or the Scottish Governments makes policy decisions that affect the tax receipts or expenditure of the other, the decision-making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving.”

That involves on-going policy decisions.

George Osborne’s interpretation of the principle did not seem to go that far. My hunch is that, because it is so difficult to give effect to, it might not result in any agreements or arrangements. The only way in which it could operate is if it worked as a disincentive to diverge, but I do not see the Scottish Government—any Scottish Government, of whatever party—doing nothing with its new powers.

**Mark McDonald:** Presumably, what you have described is effectively the long-term maintenance of the status-quo arrangement, with regard to any change that might be made. I guess that the question is: how do you measure the impact of a policy? Is there an easy way by which we could measure whether a decision that we take in Scotland about, say, the rate of income tax has a detrimental impact on another part of the UK? You mentioned the Carlisle principle, but, equally, there is a Cardiff principle. How do you measure those impacts?

**Professor McEwen:** It is extraordinarily difficult to measure cause and effect in that way, because for any development, whether it is in Scotland or in the rest of the UK, there will be multiple drivers and causes that lead to falls in revenue or decreases or increases in jobs.

Let us take Scotland’s new competencies in welfare and social security as an example. If, as result of UK Government decisions, the UK economy changes in such a way that there is an increased welfare burden in Scotland, does that mean that Scotland gets additional compensation as a result? It is extremely difficult to establish cause and effect in these cases, which is why I think that the situation is deeply problematic.

**Mark McDonald:** Of course, one could flip it the other way and say that there might be decisions that are taken in either scenario that could result in disproportionate benefit as opposed to detriment. If one area were to get a disproportionate benefit, would that count as a detriment to the other part of the UK?

**Professor McEwen:** That is a good question. I think that the intention is that, if policy decisions result in benefits in one area, that area should secure the savings from those benefits. Again, however, that is difficult to measure.

**Mark McDonald:** Would Dr Armstrong or Professor Jeffery like to chime in?

**Professor Jeffery:** The issue points to the need to have effective intergovernmental relationships. I think that Dr Armstrong was right when he talked about “no detriment” being a lawyerly phrase, bunged into the Smith process as a necessary means of getting agreement at that moment. How it works in practice is an entirely different matter. I suspect that the most straightforward way of operating something like that in practice is simply to ensure that Governments talk to each other, are aware of each other’s plans and talk about the spillover effects of those plans.

I will give you an example. There is much discussion of the fiscal autonomy that, for all sorts of historical reasons, the Basque Country and Navarra enjoy. However, that is not really full fiscal autonomy, because there are discussions with the

Spanish central Government, especially around tax competition, that lead to agreements between the areas about what each one will do. That does not undermine the principle of full fiscal autonomy; it just suggests that the practice is a negotiated one.

I suspect that, rather than the notion of the UK Government providing an authoritative report every year, what there will be is a discussion between Governments about the consequences of each other's actions across the relevant borders, and some kind of mitigation of some of those actions if both sides agree that a problem has arisen that they must do something about.

**Dr Armstrong:** I point out just that the approach seems to contradict the logic of having federalism, which is that central Government cannot possibly know all the preferences, needs and information at a local level. That is the whole point of it.

If there are greater devolved powers, it is a contradiction to then say that we need to delegate to a greater judge who can work out what all the information is and how to compensate either side. It also assumes a level of information that we just do not have. I therefore agree that a broader discussion about the potential consequences of some of these policies on both sides of the border—or across whichever borders—is the most reasonable way to approach the issue.

**Mark McDonald:** Professor David Heald has quite prominently raised the concept of tax gaming, particularly focusing on the Treasury, which, even after the Smith commission proposals take effect, will obviously have a much broader range of tax levers available to it. Isobel d'Inverno of the Law Society of Scotland suggested that perhaps what is required is a fair play clause or agreement that would ensure that gaming does not take place. Would such a clause broadly fit within the concept of no detriment, and could it easily be applied?

**Dr Armstrong:** I do not know about a fair play agreement. As an economist, I assume that people and Governments act in their own interests, so I find such notions difficult. However, I accept the premise that tax competition from either side of the border could have very serious implications.

I again point out that, if the top 10 tax earners walked out of Scotland and the top 10 tax earners walked out of England, the impact on Scotland would be much greater proportionally than it would be on England. Those issues are potentially very serious. On how to get around the problem, I can only assume that there would be a discussion beforehand of the possible consequences and whether something looks like gaming. We want to try to avoid deliberate gaming.

**Professor Jeffery:** I hesitate to step on to the turf of economists in relation to acting rationally and in your own interests. Angus Armstrong also said that a central Government cannot know all the preferences as the information situation is not good enough. That brings me back to predictability and the establishment of rules of the game, because it can be in one's interests in a multiple-play game—which fiscal policy between jurisdictions over a period of years would be—to have some kind of regularity of understandings. I therefore suspect that something like that may well emerge through the process of discussion as we encounter the situations that legislation is now bringing to us. In other words, pragmatic politics would provide a lot of the buffering for the more theoretical economic problem that analysis might suggest would arise.

**Dr Armstrong:** I agree with that in relation to regular tax policy, because it is a repeated game. If one party plays badly, there will presumably have to be a means of punishment in order to correct that, but in a repeated game one could more reasonably see how the situation would resolve itself into a pragmatic solution that would satisfy people. The situation becomes problematic when it comes to non-repeated-game issues, such as debt, because it is not a repeated game. That tends to happen very infrequently, but when it happens people stop being friends.

**Mark McDonald:** I move on to the Barnett formula. As one would expect, given the on-going election campaign, there has been much discussion of Barnett of late and talk about the guaranteeing of Barnett going forward. Professor Jeffery's submission refers to the emergence of "pork barrel politics", which is a phrase that I quite enjoy. You refer, for example, to the demands from the DUP for additional funding for Northern Ireland and the demands from Plaid Cymru in Wales, which I think is looking at parity per head of population. If we could use the old crystal ball to look into the future and imagine that either of those parties were successful in achieving those demands and those uplifts took place, how easy or otherwise would it be to continue with the Barnett formula?

11:15

**Professor Jeffery:** It would be easy enough to continue using the Barnett formula in the regular process whereby the UK Government makes spending decisions in England on areas that are comparable to those that are devolved, the population key is applied and the devolved budgets are adjusted accordingly. A side payment to Northern Ireland would render the Barnett element of funding in Northern Ireland less



significant and the directly negotiated element more significant.

**Mark McDonald:** Your understanding is that those payments would be made in isolation from further calculations as opposed to having a material impact on those calculations.

**Professor Jeffery:** Yes, except in that, if £5 billion had to be paid to Northern Ireland and £6 billion had to be paid to Wales over the length of a Parliament, there would be less funding available to spend on the comparable programmes in England, which would generate the Barnett effects, although that would be a relatively small proportion of the overall budget.

**Mark McDonald:** As the Smith commission's recommendations take effect, there will be a disaggregation of the revenue-raising powers that give rise to Barnett consequentials. Will that impact on how the Barnett formula works going forward? An element of the block grant will still need to be calculated, but will the fact that elements of revenue raising for public expenditure have been disaggregated have a material impact on how the Barnett formula can continue in its current form? Do you want to answer first, Professor Jeffery?

**Professor Jeffery:** I am happy to do so.

I do not think that there will be an impact. I am just looking for the Prime Minister's comments in *The Cumberland News*, in which he said that it is

"not about reopening discussion about the Barnett formula".

The Scottish player with a particularly strong stake in the game is the SNP, which has said in its manifesto that it anticipates the continuing operation of the Barnett formula. The point is that the amount of money that the Barnett consequentials deliver will reduce in proportion to the additional fiscal autonomy that is allocated to the Scottish Parliament. If we managed, through a phased process, to get to 90 per cent fiscal autonomy, there would be only a really small bit of Barnett consequentials left. The Barnett system could still operate as it is, only delivering a smaller amount.

**Mark McDonald:** We are discussing the fiscal framework, but that will interact with the policy framework in terms of how fiscal powers will be used to fund policy priorities. Within the package of powers that are envisaged by the Smith commission, do you see a cohesion and coherence between the fiscal powers that are going to come to Scotland and how those powers could give effect to policy priorities in areas such as welfare? That question is for Professor McEwen as well.

**Professor McEwen:** The important issue regarding welfare responsibilities is that they will

not be funded through the Barnett formula. There will have to be another way of transferring the additional revenue and calculating it, because of the way in which social security is financed—it is demand led, so it does not go through the departmental expenditure limit system. I think that how that transition will be managed is one of the issues under discussion in the new ministerial forum on welfare.

One of the reasons underpinning the identification of disability benefits and carers benefits is that those expenditures are relatively stable, although policy decisions could change that. They are not susceptible to economic cycle effects in the same way as the benefits that will merge into universal credit. In that sense, there is a clear rationale for limiting the social security powers to those stable areas, which should make it easier to facilitate a transfer of additional financial resources to meet those needs.

However, if we look at it in a different way, there are clearly knock-on effects between the areas of devolved welfare policy and the areas that would remain reserved, which, leaving aside the financial issue, creates other anomalies and potential difficulties in managing the overlap.

**Professor Jeffery:** I do not have anything to add to that except that the assumption is that there is a negotiated, one-off adjustment to the block grant, which would again shift the quantum in the other direction, as I just pointed to. That would then be subject to Barnett consequentials. Is that right?

**Professor McEwen:** I am not sure that it is clear yet.

**Dr Armstrong:** Earlier you quoted John Swinney who was talking about the discussion on the block grant adjustment that went on for many years and was then solved in 15 minutes. I understand that point, because the more you look at this the more you see that there are a lot of moving parts.

Trading off tax revenue powers against the block grant assumes that it is a zero-sum game—that you get £10 here and reduce £10 there—but the current formula has an element of risk sharing, which must be considered. Tax revenues can be very volatile—they move up and down—and you get some certainty by transferring the revenues and getting the block grant equivalent.

We must also consider how the types of revenue that remain in Scotland move together. In theory, we want to avoid a situation in which we are left with a very volatile income stream, not least because that makes budgeting much more difficult. That would take us back to the question of what happens when there is a shortfall.

There is an exception for errors but, in reality, knowing whether something is an error or whether it is the beginning of a cyclical or structural trend—because of declining demographics and so on—is very hard to observe. That is the sort of thing that the Office for Budget Responsibility strains over: whether something is a structural or cyclical element or just a forecasting error. In real time, such things are not that obvious.

It is not a simple zero-sum game; it is a complicated issue. That is why I understand why it could have taken a long time to agree the block grant adjustment. To get it right and ensure that it supports the welfare on both sides of the transaction, which is surely the objective, is not a one-to-one trade off.

**Gavin Brown (Lothian) (Con):** I will move on to a new issue. What should be the role and remit of an enhanced Scottish Fiscal Commission, first as a result of the powers from Smith, and secondly if there are greater powers to come? How would that shape up?

**Professor Jeffery:** The commission was set up with some controversy about who was on it and probably too little controversy about the resourcing that it was given, which is very slight in terms of its capacity for independent analysis. As far as I can see from the published papers, the SFC has a budget of £20,000, which is clearly not enough if it wants to do serious arm's-length analysis that informs debate and is used to hold decision makers to account.

**Professor McEwen:** I have not given the issue much thought, but I can perhaps come back to you on it.

**Dr Armstrong:** On the one hand, I would say that, because the debt is UK debt, under the current proposals—the Smith proposals—the OBR must be able to make judgments on it. Its role is to ask whether the Government is sticking to its fiscal framework, and ultimately that is what it tries to do.

Having said that, in coming to that judgment, the OBR has a lot of informal discussion with the Government about whether potential policies would be within the rules and what the implications would be. A Scottish fiscal watchdog would want to have a separate dialogue with the Scottish Government, so it would not be reasonable to expect the OBR to have a dialogue with both Governments and then say that it can somehow guarantee that there is a Chinese wall that is adhered to at all times. That would lack credibility outside. That is why it would make sense to have two watchdogs to have such dialogues.

If the figure that Professor Jeffery gave is correct, the most important points are that the watchdog should be located outside Government, that it must have people who are reputed to be

independent and that it needs to be properly staffed. If it is going to produce forecasts and we want to have reasonable ones, it stands to reason that it must be properly resourced.

**Gavin Brown:** Dr Armstrong, should the Fiscal Commission—or whatever we want to call it—be responsible for producing forecasts or should it simply comment on the forecasts that the Government produces?

**Dr Armstrong:** It has to make a judgment on whether the policies of the Government—any Government, in this case—will be within whatever fiscal rules it sets down. To do that, it has to be able to make its own forecasts. Otherwise, the Government will make a forecast that shows that the rules have been adhered to, which would undermine the point. The commission has to make a completely independent forecast of what, in its best judgment, the economy's path is going to be and, therefore, whether the fiscal mandate will be fulfilled.

**Gavin Brown:** Intergovernmental machinery has been discussed, particularly by Professor McEwen and Professor Jeffery. They basically said that it needs to be more formal than it is, and Professor Jeffery said that the German example is probably not the one for us to follow.

Let us take that a stage further. You said that the machinery should be more formal, but are there any principles that must be used? If Germany is not a good example for us, are there any international examples that would be directly relevant to us or, at least, contain elements that we ought to think carefully about?

**Professor McEwen:** It is not just about formality. There is an element of formality in that, twice a year, the Governments meet in the context of the joint ministerial committee. The timetabling of that is a little bit ad hoc, but if we have a timetable it is much easier for the Parliaments to scrutinise the JMC. That demonstrates another principle—transparency, which we have already talked a lot about.

Within the joint ministerial committee's joint secretariat, a discussion is going on about the JMC's role and remit, so it is perhaps time to revisit its purpose and remit to determine whether it is still fit for purpose as we move forward to a new, complex situation. I do not think that it necessarily is, so we need to think about what it is for.

Should the JMC be about making decisions that ultimately have to go back to the respective Governments and Parliaments for them to sanction? Is that an appropriate role for a joint ministerial committee? It might not be. It might be that decision making properly takes place in Parliament rather than in a closed-door

intergovernmental forum. However, it is time to revisit the JMC's central function.

There will be examples from other places that we can look to in order to see how interministerial or intergovernmental conferences take place on particular issues. Some will be positive and some will be negative. However, because of the peculiarities of the UK system and its highly asymmetric nature, it will always be difficult to transpose something from another context into the UK, so my hunch is that, although we can take inspiration from others, we will have to find solutions internally.

11:30

**Professor Jeffery:** I point to something that no other place has, which is the situation in which, in intergovernmental negotiations, the state-wide Government is also the representative and advocate of the biggest territorial unit of the state. That is a problematic feature of the UK arrangements as they stand. We might be at the starting point of a process of institutionalising England in some form. Clearly, that depends on the election outcome, but the Conservatives, with their plans on English votes for English laws, and the Labour Party and Liberal Democrats, as the other main parties that are represented in England, have set out prospects for some kind of constitutional process to think about England. That process of disaggregating England from the UK Government is tremendously important. In some senses, it is a prerequisite for a UK-wide system to function in a more satisfactory way.

**Dr Armstrong:** The fiscal watchdog needs to make the forecast, but the interesting question then is what happens if the OBR has a different forecast from that of the watchdog here. The two watchdogs will perhaps need to have a dialogue with each other and, as far as possible, come to an agreement. We might even want to go further and say that there has to be an agreement. The fiscal watchdog in Scotland is responsible for discussing with Government the revenue and spending implications of its policies, which it can do in isolation and that information can then be fed in, whereas there should perhaps just be a single forecast.

**Malcolm Chisholm (Edinburgh Northern and Leith) (Lab):** I will not go over all the territory that has been covered, but I seek clarification on three issues.

First, Dr Armstrong supports the Scottish Government being free to borrow under its own name in the capital markets, but he says that it is difficult to make a no-bailout commitment. Obviously, his submission goes as far as full fiscal autonomy, but I want to pull us back to Smith, or

something like it, which is no doubt what we will get. What is your position on borrowing under Smith? Are you saying that Scotland should have the freedom to borrow and that we just have to accept that there cannot be a no-bailout commitment? How do you resolve those seeming tensions and contradictions?

**Dr Armstrong:** You are completely correct to say that there are contradictions. In the little diagram in my submission, in one of the "Mixed" cells, there is much less vertical fiscal imbalance, but there are still the outstanding debt issues and the implicit reasons why support would be forthcoming, so you are entirely correct on that. That is a matter for negotiation. The most important thing is that we can never rule out support, and therefore we are always inviting a degree of moral hazard. We have identified that in many countries round the world.

The question is to what extent under the Smith package we could ensure that capital markets borrowing is seen to be properly in the Scottish Government's name, to the extent that it can be. There are a number of measures in that regard, such as the risk weights that would be put on banks holding Scottish debt and what is said in legislation about the matter, although of course legislation can always be rewritten. Those are two ways in which it could at least be indicated that the approach is supposed to be properly priced.

**Malcolm Chisholm:** Would a limit be imposed on how much borrowing could take place?

**Dr Armstrong:** That is an interesting question. My view is that it should not be, as that would undermine the freedom and responsibility. When there is a small degree of vertical fiscal imbalance, as there would be under Smith, most countries, including Canada, Switzerland and the US, do not impose such rules on their sub-central Governments. They allow them to make their own decisions. Of course, given that sub-central Governments have tax powers, they can make their own decisions. That is exactly what responsibility is about.

**Malcolm Chisholm:** I will move on to the second area, which is Barnett. Professor Jeffery, you say:

"It appears that the SNP envisages that increase flowing as conventional Barnett consequential, though it is not clear how far this takes account of the further reductions in consequential effects that any Smith powers extending beyond those of the 2012 Scotland Act would bring".

As regards the block grant adjustment, would there be any consequential effects in terms of the overall amount? Is the block grant adjustment not supposed to take account of that so that the net effect is the same? Certainly under the Smith proposals, it is assumed that the tax will raise a

certain amount of money. On the assumption that there is no change in policy within Scotland, the tax taken, the consequential and the block grant adjustment will make the same amount that they would have made previously.

**Professor Jeffery:** I think that we are still awaiting Mr Swinney's phone call to establish precisely what the adjustment in relation to the Scottish rate of income tax will be. I do not think that we have seen that yet. The Smith proposals suggest that, at that point, there should be no detriment on either side, so I think that what you suggest is about right. However, that does not mean stasis; it does not mean that there will be no change.

It is also clear in the draft bill—more explicitly than in the Smith proposals—that there should be an incentive effect for the Scottish decision-maker in using additional tax powers so that if, through their genius, additional funding is produced relative to that which is generated in other parts of the UK, it should be retained by the Scottish Parliament. Conversely, if the Parliament messes it up, it has to bear the consequences. I think that what you say would be right at day 1, but not at year 2, as it were.

**Malcolm Chisholm:** The other point about Barnett is your DUP example. Presumably, we could just feed a one-off increase into the baseline and then Barnett could continue as before.

**Professor Jeffery:** It depends on what you understand as Barnett. Most of us think about Barnett as the adjustment process year on year, which is driven in different ways for the various devolved Administrations by their populations relative to England's in respect of comparable areas of spending. You could bump up the baseline, but that would undermine the population rationale of the formula. I think that it would undermine the principles on which Barnett is based.

**Malcolm Chisholm:** I am just imagining that that is what they would do—there would be a one-off adjustment and it would be population based thereafter. Hopefully the situation will not arise, but that is me making a political point about the DUP and its prospective partners.

Finally, to go back to a scenario that we discussed earlier, I do not read *The Cumberland News*, but when I heard about the Carlisle principle I assumed that it was a hard interpretation of no detriment, in contradiction to George Osborne's soft interpretation. However, Nicola McEwen suggested that that is not clear and that it could be open to either interpretation.

**Professor McEwen:** I think that it could be. If, in the annual review, it is established that there has been a detrimental impact through whatever

process, where will the responsibility lie for addressing it? That is still not altogether clear. I read it differently. I read it more as the UK Government—or the Conservatives—assuming responsibility to step in, but perhaps that is an optimistic interpretation.

**Malcolm Chisholm:** I read it the opposite way, but perhaps that is just in the context of other remarks.

**Professor McEwen:** The issue is that it is unclear at the moment.

**Jean Urquhart (Highlands and Islands) (Ind):** That was an interesting discussion and I enjoyed all of it. I am slightly obsessed with the no-detriment clause. What do you think about the notion that we would have to have some sort of assessment of the detriment that exists?

**Professor McEwen:** Do you mean an independent assessment?

**Jean Urquhart:** Yes. I could cite a few areas in which I consider that Scotland currently has a detriment. Everyone is keen to talk about how much money Scotland gets under the Barnett formula, but there was an equation. Although the formula was not seen by Barnett as the be-all and end-all and he now believes that it should perhaps not have lasted this long, it takes into consideration the geography of Scotland: elements such as rurality, the islands, travel and transport—including ferries—and all sorts of other things.

With regard to detriment, I find it difficult to see how one might come in at some other level in relation to any change that might be considered by a Scottish Government and Parliament without taking into account the whole history of how the two—or rather, four—nations sit together.

**Professor McEwen:** On your point about Barnett, geography has been used as a justification for the proportionately higher identifiable public expenditure per head of population that we see in Scotland, but that has been the result of lobbying over the decades to maintain that differential. Barnett does not do that. It is explicitly not a needs-based formula, although it is often described as such. If we wanted a needs-based scenario, we would have to replace Barnett with something else. We would then run into issues around the politics of need and which needs are deemed more important than others.

On the point about establishing detriment, my understanding from the Smith report is that detriment as a result of policy decisions would be linked to those new powers that are part of the forthcoming Scotland bill. You raise an important issue with regard to who would be the arbiter of that. Would it be dealt with by intergovernmental

consensus or would there be some sort of independent assessment? That would bring into play the difficulty of having an assessor who was mutually respected by and acceptable to the different Governments in different parts of the UK, which would be extremely problematic.

**Jean Urquhart:** Thank you. I have another small question. Would you consider the change to stamp duty that George Osborne announced in his autumn budget statement to be an example of gaming?

**Professor McEwen:** I am not going to say yes or no to that, but it illustrates the need for co-ordination of the timing of budget statements. The mismatch between the budget cycles that the UK Government and the Scottish Government operate heightens the possibility that there will be consequences and knock-on effects—you can call it gaming if you want—of decisions that are made at one level for another level.

You could also call it policy learning, if you like. That is a slightly different way of looking at it, but you will have that as well. There is an issue with the timing and sequencing of the budget processes in the different Governments, and that will become increasingly important.

**Professor Jeffery:** When George Osborne made that announcement, I happened to be in a meeting in London at which I was sharing a platform with two senior civil servants from the Scottish Government and the UK Government respectively. As we were following the budget announcement on our phones, on Twitter and so on, the senior civil servant from the UK Government said, “There’s something in there that you’re not going to like very much.” There was probably an element of mischief in their recognising that it was a problematic issue for Scotland, but I do not think that the decision was taken for that reason—that was perhaps a nice little bonus for the UK Government.

**Jean Urquhart:** Finally, Dr Armstrong, you quote Alexander Hamilton at the beginning of your submission. Is that issued as a kind of warning or as a visionary statement?

**Dr Armstrong:** It is an example from history of the sort of thing that was an issue 250 years ago and is still an issue today. The issue of debt and shifting behaviour, which we now call moral hazard, has been around for hundreds of years, and it would be brave to assume that it will not be around in the future.

**The Convener:** Thank you very much. I also thank my colleagues round the table. Unless our witnesses want to make any further points, I will wind up the session. Thank you for your time and your contributions, which are very much appreciated.

As that was the only item on our agenda, I now close the meeting.

*Meeting closed at 11:46.*



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