



The Scottish Parliament  
Pàrlamaid na h-Alba

## Official Report

### FINANCE COMMITTEE

Wednesday 20 May 2015

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**Wednesday 20 May 2015**

**CONTENTS**

	<b>Col.</b>
<b>SUBORDINATE LEGISLATION</b> .....	<b>1</b>
Public Services Reform (Scotland) Act 2010 (Part 2 Extension) Order 2015 [Draft] .....	<b>1</b>
<b>FISCAL FRAMEWORK</b> .....	<b>10</b>

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**FINANCE COMMITTEE**  
**15<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:**

Professor John A Beath (Royal Society of Edinburgh)

Professor David Bell (University of Stirling)

Professor Michael Keating (Centre on Constitutional Change)

Professor Ronald MacDonald (University of Glasgow)

John Swinney (Deputy First Minister and Cabinet Secretary for Finance, Constitution and Economy)

**CLERK TO THE COMMITTEE**

James Johnston

**LOCATION**

The Robert Burns Room (CR1)



# Scottish Parliament

## Finance Committee

Wednesday 20 May 2015

*[The Convener opened the meeting at 09:15]*

## Subordinate Legislation

### **Public Services Reform (Scotland) Act 2010 (Part 2 Extension) Order 2015 [Draft]**

**The Convener (Kenneth Gibson):** Good morning, and welcome to the 15th meeting in 2015 of the Finance Committee of the Scottish Parliament. I remind everyone present to turn off mobile phones, tablets and other electronic devices.

Our first item of business today is to take evidence from the Cabinet Secretary for Finance, Constitution and Economy, John Swinney, on subordinate legislation on the Public Services Reform (Scotland) Act 2010. Mr Swinney is joined by his official, Victoria Bruce. I welcome our witnesses to the meeting, and invite the cabinet secretary to make a short opening statement.

**The Deputy First Minister and Cabinet Secretary for Finance, Constitution and Economy (John Swinney):** Thank you, convener. The Scottish Government is seeking to extend part 2 of the Public Services Reform (Scotland) Act 2010 for a further five years. That part of the 2010 act came into effect on 1 August 2010, but due to the addition of a sunset clause during the passage of the bill, its powers will expire on 1 August 2015.

Part 2 allows ministers to make orders to

“improve the exercise of public functions, having regard to ... efficiency ... effectiveness, and ... economy”,

and to make orders to “remove or reduce” burdens. Eight orders have to date been made under part 2: three have been made under section 14 on efficiency, effectiveness and economy, and five under section 17 on removing or reducing burdens.

In summary, the orders have declassified the General Teaching Council for Scotland as a public body and turned it into an independent professional organisation; transferred the functions of the Public Standards Commissioner for Scotland and the Public Appointments Commissioner for Scotland to the new Commissioner for Ethical Standards in Public Life in Scotland, at the request of the Scottish Parliament Corporate Body; created the roles of prison monitoring co-ordinator and independent prison monitor, and transferred the functions of prison visiting committees to those

roles; provided the basis for measures to provide greater confidence in the working relationships between landlords and tenant farmers; enabled ministers to recover the costs of Education Scotland’s inspection of independent further education colleges and English language schools; helped to streamline and simplify the planning system in two specific areas; and allowed NHS National Services Scotland to provide shared services across the public sector with a view to improving efficiency and productivity.

Although, during the passage of the bill, committee members expressed concerns that the powers in part 2 might be misused, the fact that a relatively small number of orders have been made, to make important but small-scale changes, should provide reassurance that the powers have been used appropriately. In each case, the orders were subject to full public consultation and parliamentary scrutiny and, where necessary, to amendment.

Where significant changes to the public bodies landscape have been proposed, those have—quite appropriately—been delivered through primary legislation. A recent example is the merger of Historic Scotland and the Royal Commission on the Ancient and Historical Monuments of Scotland, which was done through the Historic Environment Scotland Act 2014.

It is vital that we retain the order-making powers for another five years because they provide the Government and Parliament with flexibility to make changes quickly, as and when opportunities arise, without introducing primary legislation. Streamlining and simplifying the public bodies landscape is a continuing process, and wider developments such as the further devolution of powers to Scotland and the on-going challenging financial context mean that the powers continue to be relevant and necessary.

I reassure members that the additional safeguards that were introduced by Parliament during its consideration of the eventual Public Services Reform (Scotland) Act 2010—including in relation to consultation and scrutiny—will remain in place, in response to points that were raised by the Delegated Powers and Law Reform Committee that the Scottish Government has not revised its approach to consultation. We continue to believe that consultation is an important aspect of Scottish Government working methods that should be carried out on proposals for legislation, except on rare occasions like this.

As the order seeks only to extend the duration of part 2 of the 2010 act, and as the provisions themselves contain no detail, the only views that a consultation could have elicited would have been for or against continuation, and would not have led to any changes to the order. It is therefore unlike

the vast majority of legislation, on which full and substantive consultation on provisions can take place.

We consider that the best evidence on the impact of part 2 is the way in which it has been used in practice since it came into force. On each occasion, the orders have been subject to full consultation. There have been no communications to the Scottish Government since the enactment of the 2010 act suggesting that the powers have caused problems or have been used in an inappropriate manner.

The Scottish Government continues to believe that the powers provide an essential mechanism for making small-scale changes to public functions. Ultimately, it is for Parliament to decide whether or not the powers should be continued on the basis of their past use and potential future use in relation to improving efficiency, effectiveness and economy, and removing and reducing burdens.

I am happy to answer questions.

**The Convener:** Thank you for that opening statement. You of course touched on the issue that has come to prominence and which is raised in the response of the Delegated Powers and Law Reform Committee. It wrote to me about consultation, and you talked about your thinking behind that, but I will highlight some of the issues that the DPLRC has raised. It said that it

“is concerned to note that the Government takes the view that it is unlikely that stakeholders would have any particular views on the matter.”

Furthermore,

“it considers that for members to make an informed decision there would have been benefit in having the findings of a consultation exercise to draw upon”.

The committee also notes

“that individual occasions on which the powers are exercised have been the subject of consultation but that such instruments raise an entirely different issue to that posed by the current draft order.”

The convener of that committee, our colleague Nigel Don, has therefore asked the Finance Committee to pursue the matter. Given the concerns—of which I know you are fully aware—that have been raised by the DPLR Committee, will you say more about your thinking on the matter?

**John Swinney:** The issues around provision of the powers in the Public Services Reform (Scotland) Bill in the first place were well exercised in parliamentary debate; indeed, the Government responded to the discussions and debate at the time in the provisions that were finally enacted—in particular, the sunset clause.

We now have the benefit of having seen over five years how the power has been utilised: it would be impossible to sustain an argument that the power has been used for any purpose other than that for which it was originally conceived. As I said in my opening remarks, since 2010 the Government has received no representations that suggest in any way that it has used the powers for any other purpose. Therefore, the judgment that I arrived at was that, given that any change that we would undertake using the powers in the 2010 act would itself be subject to consultation and full parliamentary scrutiny as a consequence, the mere continuation of that responsibility, which has been properly, fully and exhaustively debated in Parliament, did not merit a specific consultation. That was the basis of my judgment as to why it is appropriate to proceed as we have done.

**John Mason (Glasgow Shettleston) (SNP):** As the cabinet secretary will probably know, I am a member of the Delegated Powers and Law Reform Committee, at which some concern was expressed. On the principle, if not many measures have been taken forward using the power in the past five years, why do we need to continue the power for another five years?

**John Swinney:** We have made eight orders. If we had not been able to use the approach that is provided for in the 2010 act, those changes would either not have taken place or would have required more exhaustive primary legislation. I deliberately went through the range of subjects that have been addressed under the provision—they have been minor amendments to the landscape of public bodies. They are the sorts of things that were in the past habitually left unattended until a primary legislation vehicle came along that would enable them to be done. When that happens, the parliamentary debate is often about the fact that the Government is addressing a multitude of topics all crammed together in one piece of primary legislation. That raises concern in Parliament about the focus of the primary legislation.

The power has given us the ability to deal with relatively minor issues. Such minor issues will, I think, continue to occur as we continue to amend the public bodies landscape in Scotland and to address such questions. As a consequence, the power is a useful and practical one to have at our disposal, because it avoids recourse to more time-consuming primary legislation.

**John Mason:** On the specific point about consultation, we know that the 2010 act was quite controversial when it was passed, and a number of groups made the point that their independence might be compromised. I presume that the sunset clause gave some reassurance that, if there were problems and issues with independence, the

legislation would be in force only for a limited time. You say that those groups have not made many comments over the past five years, but we are not going out to ask them whether they have any comments to make. Do they still have those fundamental concerns about independence? We do not know, do we?

**John Swinney:** When the 2010 act was passed, a lot of comments were made in Parliament about the nature of the provisions and what they would be used for. All sorts of suggestions were made about how the powers would be misused, but there is not a scintilla of evidence to support the rather lurid comments that were made when the legislation was passed in 2010. From that point of view, there is considerable reassurance about the practical utilisation of the powers of the Government, which were conferred by primary legislation that Parliament clearly voted for. The powers have been exercised in that effective way. I am pretty sure that, if people had issues and concerns about exercise of the powers, we would have heard about them. However, we have not heard that over the five years. My perspective is that Parliament legislated for the powers and provided the opportunity for them to be extended if Parliament so chose; Parliament has been invited to do that today.

**John Mason:** One of the considerations regarding whether there needs to be a consultation is the history of the policy area. Do you accept that because the policy has been controversial, history suggests that there should have been a consultation?

**John Swinney:** No, because the responsibilities that the order will continue have been exercised in a way that has not given rise to any concerns such as were put to Parliament back in 2010. All sorts of speculation was put to Parliament in 2010 by people who opposed the provisions that the Government was pushing to put in place. When we look at developments since then, we see that there was no substance in those concerns.

A provision that Parliament properly and effectively legislated for will simply be extended by the order that is before the committee today. In addition, any action that follows on from or arises out of that will be the subject of consultation. There is, therefore, the protection both of consultation and of parliamentary scrutiny and decision making in relation to all such orders. The crucial point is that Parliament itself legislated for the provision five years ago and judged that it is an appropriate power, and the history of our exercising the power has been entirely consistent with what I told Parliament at the time would be the case.

**Gavin Brown (Lothian) (Con):** You indicated that you used primary legislation to confer the powers. If the order is agreed to today, is there a firm Government commitment to continue in that vein so that any significant changes to the public sector landscape, should there be any, will be made through primary legislation, and that you will use the powers in a broadly similar way to the way in which you have used them over the past five years?

09:30

**John Swinney:** I propose to use the powers in an entirely similar way to the way in which I have used them over the past five years. The key point to make in addressing that question is that the way in which I have exercised the powers has been entirely consistent with what I told Parliament in the run-up to enactment of the Public Services Reform (Scotland) Act 2010. I am very happy to confirm that our actions will be entirely consistent with what has happened in the past five years and with the explanation and assurances that I gave Parliament five years ago.

**Gavin Brown:** At the time when the Government sought the powers, it was envisaged that the public sector would be going through a huge amount of reform. One of the arguments that the Government gave for having the powers—as a review of the debates that took place at the time seems to show—was that reform meant that the Government needed to be fleet of foot, and it was thought that five years was an appropriate period. This is not an easy question to answer, but do you envisage the powers being held by Government in perpetuity and simply being renewed every five years, or is it your view that if the order is agreed to, we will probably not need such powers in five years?

**John Swinney:** The changes that have been made through use of the powers have been minor alternations to the public sector landscape. I am looking well into the future here, but I think that in the real world such minor changes to the landscape will probably continue. There will be major reforms of the public sector landscape in Scotland but—as Mr Brown quite rightly highlighted—those changes will be made through primary legislation, because they will require to be subjected to the extensive and full scrutiny that is appropriate for such major changes. Without prejudging what the situation will be in five years' time, I imagine that there will still be a need for minor alterations of the kind that we have already used the powers to make.

**Malcolm Chisholm (Edinburgh Northern and Leith) (Lab):** You said that Parliament gave its approval for the relevant part of the Public Services Reform (Scotland) Bill, but it did so for

five years. Regardless of the merits of the case, is there not an issue about the nature of a sunset clause and what Parliament's intention is when it insists on a sunset clause?

**John Swinney:** That is correct: it is precisely why the committee is considering an order that provides for exercise of the powers to be extended for a further five years, provision for which was made in the primary legislation. Parliament has provided for that to happen; it cannot happen automatically—there has to be parliamentary scrutiny and consideration. Use of the powers has been entirely consistent with what I proposed to Parliament five years ago; I think that that serves as the basis for a framework of parliamentary assurance.

**Malcolm Chisholm:** Would it have been such a big problem to consult? It might even have proved your case for you if all the people who had been concerned had written in to say, "It's fine. We don't have a problem with this any more." My point is about the nature of a sunset clause. Is there not a requirement to look at the issue afresh after five years? When legislation is considered afresh in the Scottish Parliament, it is normally consulted on.

**John Swinney:** For me, the issue is largely to do with the way in which we have exercised the responsibilities in question. If we look back at the reasons that I was accused of having for wanting to take the powers back in 2010, the evidence does not substantiate the argument that was made. The arguments were well rehearsed in 2010; Parliament made provision for the provisions to be extended if it so chose, and the manner in which the powers have been exercised is entirely consistent with that approach. Therefore, we are in a position in which Parliament can take that decision today.

**Malcolm Chisholm:** Have you considered any precedents on the treatment of sunset clauses in previous legislation?

**John Swinney:** There will be a variety of examples in which consultation took place and in which it did not take place. My judgment on the point was relatively straightforward to arrive at: the powers had been provided for, our actions had been consistent with what we had said to Parliament, therefore there was an argument for extending the powers in this fashion.

**Richard Baker (North East Scotland) (Lab):** You said that the powers have been used eight times over the past five years. Do you expect that they will be used more frequently or less frequently over the next five years?

**John Swinney:** It is difficult to say, but I envisage the powers being used in similar circumstances. Therefore, whether they are used

once or 20 times, it will be only for minor changes to the landscape of public bodies. However, in all circumstances, changes will be consulted upon individually as a consequence of any order being laid under the powers.

The general point that Mr Brown pursued in his questions concerned whether we were dealing with an entirely static public sector and public bodies landscape. The answer to that question is no. We will face changes and I imagine that we will have to make changes on the basis of efficiency and economy, as the 2010 act provides for. However, it is not possible at this stage for me to provide a definitive view on how often the provisions will be used.

**Richard Baker:** The powers could be used far more often over the next five years, depending on the agenda for public sector reform. Given that, would it not have been better to take a belt-and-braces approach and ensure that there was further consultation at this point before we embark on a period in which they might be used more frequently than they were over the previous five years?

**John Swinney:** No, because the assurance to Parliament—which I put on the record in response to Mr Brown—is that the use of the powers would be entirely consistent with the type of changes that we have made and that we suggested in parliamentary debates during the passage of the Public Services Reform (Scotland) Bill.

**Richard Baker:** If, in five years, the Government proposed to extend the powers again for a further five years, would it be acceptable to say again that there was no need to consult on the provisions, even though it would be 10 years since the act had been passed?

**John Swinney:** That judgment would have to be made at that time. Ministers would have to come to a view then. The way in which we have exercised the powers demonstrates that we have remained entirely faithful to the commitments that we gave to Parliament in 2010.

**Jean Urquhart (Highlands and Islands) (Ind):** My question was answered in your responses to Mr Brown and Mr Chisholm on when the sun sets on a sunset clause. We have clearly been canny about using the legislation, but if—God forbid—you are not the cabinet secretary, would there be any opportunity for abuse? There was clearly anxiety in the debates on the bill, which allowed for a temporary fix.

**John Swinney:** I do not think that an opportunity for abuse exists for three reasons. First, the power would have to be exercised consistently with what I said to Parliament during the passage of the 2010 act. To be frank, if a minister were trying to undertake major reforms of



the public sector landscape through the power, their argument would have poor foundations because that change would exceed what I put on the parliamentary record in 2010 so they would struggle to sustain that argument.

Secondly, any individual instrument must be the subject of separate, distinctive consultation and parliamentary scrutiny, which provides protection.

Thirdly, there are now five years of precedent; if a minister were to propose more significant change that one considers would merit primary legislation, that body of precedent would be against their argument.

Every one of the orders that we have laid has been subject to consultation—this relates to the core question of consultation, with which the committee has wrestled—so stakeholders had the opportunity to say that the change in each provision was outwith the spirit of the 2010 act. That did not happen.

There is now established practice about how the powers can be exercised and ministers would be unable to sustain an argument if their actions were not consistent with the three elements that I have set out.

**The Convener:** That concludes questions from the committee.

*Motion moved,*

That the Finance Committee recommends that the Public Services Reform (Scotland) Act 2010 (Part 2 Extension) Order 2015 [draft] be approved.—[*John Swinney.*]

*Motion agreed to.*

**The Convener:** The committee will now publish a short report to the Parliament setting out its decision on the draft order.

I thank the cabinet secretary for attending.

09:41

*Meeting suspended.*

09:45

*On resuming—*

## Fiscal Framework

**The Convener:** Our next item of business is to continue to take evidence for our inquiry into Scotland's fiscal framework.

I welcome to the meeting Professor Ronald MacDonald, Professor Michael Keating, Professor John Beath and Professor David Bell.

Members have received briefing papers from our witnesses, so we will go straight to questions. The normal process in the committee is that I start with a few opening questions and then open up the discussion to colleagues around the table. I am sure that you all know the drill. If I ask a specific panellist a question that others wish to comment on, they should feel free to come in. I hope that we will have a wee bit of interaction among the panellists.

The first question is to Professor Beath. The second paragraph of the summary in the Royal Society of Edinburgh's submission says:

"It is crucial that the process allow sufficient time for deliberative consultation".

The \$64,000 question is: how much time?

**Professor John A Beath (Royal Society of Edinburgh):** If one was going to put a figure on it, I suppose that one would have to say more than a year. The reason for that is very simple. If you want an enduring settlement, you have to be sure that you have in place a fairly clear and robust framework, and developing such things inevitably takes time. People need to be consulted and the framework needs to be tested out in simulations to see whether it works as it is thought that it might work or whether it needs to be corrected. If you suddenly jump into a framework, adopt it and find that something goes wrong six months down the line, you have a problem. I am sure that nobody wants that sort of problem. That is exactly why we say that a proper process is needed.

**The Convener:** The Calman commission was proposed in December 2007, and some of its recommendations have still not been completely rolled out. A vow was made in September last year, and political commitments have been made to the electorate about implementation timescales.

If the process went on for more than a year, would many people feel really disappointed? Perhaps "betrayed" is too strong a word—I do not know—but would there be a backlash because the rolling out of additional powers that were promised was being inadvertently or deliberately delayed?

**Professor Beath:** There will always be people who will be concerned about delay. It is how the delay is explained to them that matters.

I go back to the phrase that is in the title of the command paper: it is a matter of ensuring that we have “An enduring settlement”. I think that most people would realise, if it were explained to them, that it would make sense to ensure that we have all the pegs in place before we suddenly start to play the game.

**The Convener:** Obviously, people would then ask why a promise was made to deliver within a year if there could not be delivery within a year.

**Professor David Bell (University of Stirling):** I do not want to go into the politics of the matter.

**The Convener:** Indeed.

**Professor Bell:** However, I agree with Professor Beath that, if there is to be an enduring settlement, there has to be in place a piece of legislation that makes sense and an administrative system that will be workable. As you said, the arrangements for the Scotland Act 2012 are still not in place. There still seems to be some doubt around the definition of Scottish taxpayers and not complete clarity around the block grant adjustment mechanism. It may be difficult to explain to people that these things take time.

Although it may be possible to put legislation in place well in advance of the powers coming into force, it is difficult to say whether that would suffice. Legislation has to be thought through very carefully before it is put on the statute book.

**The Convener:** If it can be, should the fiscal framework be agreed before the legislation is passed?

**Professor Bell:** I think so. There are huge questions of detail and we would want a situation in which there is no opportunity for retrenchment post the legislation being put in place. That means a huge amount of work in a very short time, and I would be wary of that.

**Professor Ronald MacDonald (University of Glasgow):** I broadly concur with my colleagues. If we look at the process, we can see that a lot of it has been done on the hoof, if I may say so.

In the work that Paul Hallwood and I did on fiscal autonomy, going way back to the early 2000s, we made a strong case for some form of fiscal devolution or fiscal autonomy. In our work we have an interesting little model, which is the threat-of-secession model. In that model, we predict that enhanced devolution powers—the powers that we are going to see—will come about once we see threats of secession. That is exactly how the process has been. It has not been done on a scientific basis. The key element that people

have focused on is the attempt to address the vertical imbalance of the fiscal gap. We seem to have moved quite a lot in that direction.

More generally, there has not been a proper discussion about what framework the Scottish Government needs to implement its policies. That is part of the problem. What do we need? What is the optimal mix of taxes, tax devolution and expenditure devolution? How is expenditure financed in terms of borrowing and so on? Those are things that we cannot decide very quickly because there are other consequences—I mention some of them in my submission—in relation to what happens to prices and competitiveness in a monetary union where we have devolved taxes.

There are lots and lots of issues that people have not even begun to discuss, so I suggest that we proceed with caution because we have to get it right. If we do not get it right, the consequences for the electorate could be much worse than going ahead with something that is not properly thought through.

**Professor Michael Keating (Centre on Constitutional Change):** I do not know what the constitutional status of the vow was, but it was produced very late in the campaign, when 20 per cent of people had already voted. At the election, all the parties said that they would implement it. That is hardly a mandate—it is hardly as though it was something that became part of the referendum campaign or the subsequent general election campaign.

However, things have changed since the general election. We now have a majority Conservative Government that seems to be committed to reducing the scope and size of the state over the long term as a percentage of gross domestic product, if not in absolute terms.

Scotland voted very differently, but if the trends in England in particular continue as at present, we may see radical restructuring of the state. It is difficult to see any majority in this Parliament going in that direction. The question is whether, in Scotland, we want to continue to consume as much by way of public services and less by way of private consumption than is the preference in England. If we do, do we want to pay for that by taxation or by charging, whether through university fees, prescription charges or whatever?

There are implications for the levels and types of taxation. All the proposals for devolution of taxes either assume that we will have broadly the same mix and size of public services in Scotland as in England—which may not be the case—or have been tied to proposals for cutting taxes, which goes in exactly the opposite direction from what I am suggesting. It might be that there is a political preference in Scotland for more public

services, so the level of taxation would have to be higher. If we accept that, there are huge implications for the kinds of taxes that we have—whether we have a broad base of taxation, whether we have taxes that are buoyant and whether we have taxes that can actually be used.

I do not think that the Smith commission proposals met any of those requirements, so we need to go back to first principles and think things through again. That will take us at least a year or two, but we have a five-year Parliament at Westminster and Scottish elections that are coming up next year, which will be important and will make it even more difficult to get this thing through quickly. I think that we have time to get it right. It would be a mistake to rush through the Smith proposals now, because we will certainly have to revisit them before too long.

**The Convener:** I think that the panel's views on that issue are quite clear—although colleagues might wish to explore it further.

I will continue with the Royal Society of Edinburgh's submission. Professor Beath, you talk about

"Establishing fiscal institutions that can provide independent and rigorous analysis and review."

You go on to say:

"The RSE is firmly of the view that there is a need to establish in Scotland an independent fiscal body to provide authoritative and independent forecasts of the future fiscal revenues and budget position."

Where does the Scottish Fiscal Commission fit into that framework?

**Professor Beath:** If you are looking for something to build on, there is a brick in place at the moment, which is the Scottish Fiscal Commission. It is very small, it is not particularly well resourced, and it certainly does not have the capability to conduct the sorts of exercises, analysis and scrutiny of policy that would seem to be necessary if one has to have proper independent auditing, if you like, of what goes on.

We mention that the Congressional Budget Office in the United States provides a very useful model. That is a well-resourced organisation that does extraordinarily good work. It may be possible to somehow mix the Fiscal Commission and the Scottish Parliament information centre. I do not know—that is not something that I am an expert on—but there are bits in place. There are some foundation piles there, but you need a whole building in place to carry out such an exercise.

**The Convener:** For clarification, are you suggesting that the Scottish Fiscal Commission should be expanded or replaced, or that there should be a parallel body? Where do you see the commission fitting into your suggestion?

**Professor Beath:** I would recommend that there should be a properly independent body. That is all.

**The Convener:** You do not think that the Fiscal Commission is independent. The people who are on the Fiscal Commission are pretty vigorous in their defence of it as an independent body, but you do not believe that it is.

**Professor Beath:** I am sure that it is independent—I do not think that that is an issue—but it just needs to be larger and rather more permanent in the way in which it meets and debates. It is a matter of having in place an Office for Budget Responsibility or something like it, and the Fiscal Commission is not such a body.

**Professor Keating:** The Scottish Fiscal Commission is critical for technical reasons, in that it gets the data out there. It is also critical that it is independent and is seen to be independent of both Governments. That makes a huge difference. It should be able to initiate inquiries on its own—it should not simply review the Scottish Government's forecasts; it should have a more proactive role. In that regard, it is very important that it is directly responsible to the Parliament, not to the Government. The Congressional Budget Office is of course a much bigger operation than a body here would ever be, but it is a useful model because of its statutory independence.

**The Convener:** I think the Cabinet Secretary for Finance, Constitution and Economy would have a heart attack if he thought that it would be as big as the CBO, but I take your comments on board.

**Professor MacDonald:** I echo what colleagues have been saying. The Fiscal Commission needs to be bolstered. As people have been saying, it needs to be independent. It is on a bit of a shoestring budget at the moment, so I think that more resource has to be devoted to it. The commission has to do its own forecasting, rather than rely on Scottish Government forecasts. Only then will it become independent, or be seen to be independent.

Therein lies another issue. The Scottish Government really needs to improve its data. I know that steps are being taken to improve the GDP data, but we do not have proper breakdowns of price data. It is difficult to see how the Fiscal Commission can do its job properly if we do not have a good data set, so we need to put resources that way as well.

10:00

**The Convener:** I deliberately kept your answer to my question until last, Professor Bell, because you have a specific section on data in your submission. You touch on the Scottish national

accounts project—SNAP—which the committee asked about last week. You say that we need to identify

“where improvements might be made in both accuracy and timing.”

Should the Scottish Fiscal Commission be beefed up considerably? Should there be, as I asked Professor Beath, a separate body? Can you provide clarification on that? Also, how could the data be improved? That is an issue of concern for the committee going forward.

**Professor Bell:** I go along with my colleagues that not only must the Fiscal Commission be independent, but it must be seen to be independent. Perceptions really matter in that respect. I think that the OBR is now accepted as an independent body, but there was quite a lot of suspicion about it in its early days. I do not think that we need to go down the same route as Westminster in relation to the construction of an independent body, but the key thing is that it is independent and carries out a set of functions that are appropriate for whatever Scotland's fiscal framework is going to be.

I also go along with the idea that a body that was located in the Parliament would carry a great deal of weight, but there are other models. In Germany, there are the wise men in different universities who provide the oversight of German fiscal policy. Nevertheless, the Office for Budget Responsibility has a long and distinguished history, so there must be something there that would be worth looking at.

Whatever the body is, it will have to work quite closely with the OBR. For example, the way in which the block grant adjustment works relates to the relative rate of growth in the tax base in Scotland and the tax base in England and the rest of the United Kingdom. The Scottish body will have to take somebody's forecast or develop its own view of how fast the rest of the UK economy is growing before it can forecast the Scottish budget, and that will require a degree of interaction with the body south of the border.

In relation to new powers, it is important to improve the information that we have around the tax base and tax revenues. One small point is the importance of understanding the 1 per cent—the top income earners who supply around 11 per cent of total income tax revenues. There are not all that many of them, and if income tax is to be the key part of Scotland's fiscal structure, it will be extremely important to understand how tax revenues are generated and by whom. We have some experience of that, but we will have to learn a lot more about welfare benefits. The Department for Work and Pensions has a lot of statistics on welfare benefits, and it seems that there will be a

need for some institutional agreement with the DWP about how those are accessed and the purposes for which they are used.

That is a minimum in terms of data requirement, because it focuses just on the new powers, but behind that is information about all the other macro-type variables that SNAP has tried to address. We need to get that in a more timely fashion and we need to be satisfied about the degree of accuracy that is embodied in it. Funnily enough, only yesterday I looked at some estimates of Scotland's gross operating surplus as part of SNAP. The estimates are based on a lot of assumptions, so, as assumptions are not always correct, to some extent you pay your money and you take your chance.

**The Convener:** Yes. The more assumptions that are made, the harder it is to get an accurate result.

I move on to Professor MacDonald's submission. On Barnett, you state that

“Once the block grant has been decided,”—

following all the changes that we have touched on—

“and absent a no detriment clause, it may be possible to use a method of indexation to adjust the block grant moving forward.”

Do you have any views on what form that indexation could or should take?

**Professor MacDonald:** I proposed a while back that we could maybe look at the economic cycle in Scotland and index it in terms of GDP movements relative to some base. However, the important point is that there would need to be some reform of Barnett, so we are talking about a revised version of Barnett—some kind of block grant that I presume we would still need going forward.

One idea that I put forward in my submission is to have something along the lines of the Australian Commonwealth Grants Commission, whereby on a year-to-year basis the various regional components of Australia put in bids for their desired spending and the commission has to either agree or deny those unanimously. If it denies them, a simple GDP rule along the lines of what I mentioned earlier is used to mechanistically roll spending forward. That is perhaps not the optimum way of doing it if the desired spend of the Scottish Parliament is different from the figure that is produced by that rule.

**The Convener:** You have also touched on no detriment. I think that the whole idea is that, once everything settles down, the benefit would accrue to Scotland if the Scottish economy grows above the UK average and, if it does not, Scotland would take the hit. We are looking at the creation of a mechanism that would allow that to happen

without other factors coming into play. That is the kind of thing that we are trying to wrestle with. A couple of presentations that were made at the committee's away day showed how difficult it would be to achieve that aim. Does Professor Keating, who I think was at the away day, have a view on the issue?

**Professor Keating:** Barnett needs to be addressed, but we have been saying that for the best part of 40 years, and I have been around all that time talking about it. However, Barnett is becoming really problematic, because it does too many things that are not consistent. It provides revenue that is not raised by taxes in Scotland and, according to some descriptions, it is also supposed to be an equalisation mechanism, but it is not and it never was. It is a counter-cyclical mechanism to cope with asymmetric shocks, so that Scotland is not dependent on its own revenues if there is a downturn in the Scottish economy. Those are all very different things.

Those basic principles about what Barnett is supposed to do are reflected in the individual problems that are generated when we talk about indexation and so on. The discussion becomes very technical, but there is a problem of principle. The various proposals—the Smith proposals and so on—say that Barnett will continue. However, Barnett has never been defined, so Barnett is whatever the Treasury says that it is. The Treasury did not even use the term “Barnett formula”. When the term was invented by our colleague David Heald, Lord Barnett immediately said, “Don’t put my name to it.” Nevertheless, the phrase is thrown around as though it really means something.

Whatever we get after Smith will not be Barnett in the recognised sense; it will be something else, so maybe we should have a different name. That would get us away from the incubus of thinking that it is going to be the same thing.

Also, talking about Barnett gets in the way of talking about other things. As long as we just tweak Barnett, which is essentially driven by changes in expenditure in England—although other things are now laid over that—we cannot talk about all kinds of other things or talk about Scottish expenditure in a coherent way as being something other than derivative of decisions that are taken in England. That pops up again in the debate about English votes for English laws or English votes for English taxes. People say that we cannot do this or that because we have Barnett. It has almost become the foundation stone upon which everything else is built, which is very unfortunate. We have to close off all kinds of things just because of Barnett.

It is immensely difficult to reform Barnett, because we would have to agree on other

principles, but it would be better to face up to those issues head on rather than pretend that what we have is still Barnett and keep on tweaking it in all sorts of complicated ways. The experience of other countries that have tried to do this is that it is a mixture of technical formulas, equalisation settlements and a fair dose of politics. That is the reality. Nevertheless, it would be useful to lay down some principles and try to get agreement on them.

We know that there will be a lot of political haggling and that we will end up with something between where we are now and where we would ideally like to be, but simply muddling through is not good enough. It is also causing immense irritation in other parts of the United Kingdom, where Barnett is interpreted—in yet another way—as something that just benefits Scotland. That is a very misleading interpretation, but it is the interpretation in other parts of the United Kingdom. At some point, that has to be addressed if we are going to have a stable settlement.

**The Convener:** Professor Bell, do you want to comment?

**Professor Bell:** I agree with that last point, which is perhaps the main point that the Royal Society of Edinburgh makes in its submission. Again, that is an argument for taking a longer time. We really need a set of principles around risks that are shared across the whole of the UK and risks that will be dealt with specifically on a Scottish basis. Whatever is in Smith, there are not many principles.

**The Convener:** Professor Beath, I kept you until the end in relation to this question because there is a comprehensive section on Barnett in your submission. You say that

“there is a need to reconsider the use of the Barnett Formula as the basis for determining the fiscal relationships”,

although of course we have just fought an election in which all the political parties were committed to retaining Barnett. You say:

“The principle of needs-based funding means that revenue support should be allocated on the basis of some proper assessment of need.”

I would be interested to hear how, in your view, that would impact on Scotland. You also say:

“Should the block grant continue to be determined through the operation of the Barnett Formula ... there must be a mechanism through which the UK and Scottish Governments can negotiate and agree on adjustments in an open and transparent manner. It is certainly not acceptable for HM Treasury, as an organ of the UK Government, to make such decisions unilaterally.”

**Professor Beath:** Yes. It is fairly clear that, as we move into a much more complicated set of devolution relationships, with Wales and Northern

Ireland to think about as well, there needs to be a fundamental rethink of the way in which revenues and expenditure are shared. We have to sit down and think about which risks are best carried at a national, UK-wide level and which are best carried at a local level.

There is also the question of fairness. One wants fair outcomes. A fair outcome might, for example, be a system in which, when there are unexpected negative shocks in one part of the economy, another part where they are not present makes a transfer of resources. That is the kind of fiscal sharing relationship that you should have in mind. The actual structure and mechanisms are matters for determination by experts. I am not an expert on the workings of the Barnett formula and other types of financial transfer mechanisms, but there is plenty of expertise out there—on my left and on my right.

10:15

**The Convener:** Before I allow colleagues to ask questions, I have a final point, which is with regard to your paper, Professor Bell. You say:

“The fiscal body should ... perhaps be asked to monitor Scotland’s ... tax ‘gap’”,

which is

“the difference between tax collected and that, which in HMRC’s view should be collected.”

In a previous paper, you

“suggested that in 2007-08 Scotland would have a potential shortfall on its self-assessment returns of around £550m”.

Why is the gap so large? Is it identifiable? What mechanism can be put in place so that both Governments, north and south of the border, can reduce the gap?

**Professor Bell:** That is the so-called tightening of tax avoidance issue. The estimate by Her Majesty’s Revenue and Customs has been out there for some time.

Part of the trouble is that politicians are always willing to say, in the run-up to an election, that they will shore up their finances by reducing tax avoidance, and then that tends not to happen. With a very complex tax system, it is difficult to ensure 100 per cent compliance with what we think is the aggregate taxable income that is out there.

A paper that has been published in the past few days suggests that the effort that is put into tax avoidance increases with the topmost rate of tax, which means that increasing the top rate will not result in the increase in revenues that might be expected, because people will put more effort into tax avoidance. Tax avoidance is always a choice—people weigh up its costs and benefits,

and the greater the benefits, the more likely they are to go for it. In a complex tax system, there tend to be ways round regulations that allow people to put money in different forms that the taxman cannot access.

I do not have an immediate solution to the problem. One of the issues that may be created as a result of the new taxes is that it will be possible to play off the authorities north and south of the border in relation to one’s tax liabilities.

**The Convener:** I am almost tempted to ask Professor McEwen, who is a tax expert and the committee adviser, but he is not on the witness panel so I will move on. Do any other members of the panel wish to comment on that? I notice that you were writing down some notes, Professor Beath.

**Professor Beath:** Some interesting research is going on at the University of Exeter in conjunction with the University of Kent. There is a thing called the tax administration research centre, led by Professor Myles, which has been testing the insights of behavioural economics in field experiments to try to find methods by which the tax gap might be closed. There are some interesting questions there on issues such as how we pre-populate tax forms. Are there certain things that could be filled in in advance that would encourage people to tell the truth? There is potentially some interesting work out there.

**Professor Bell:** In relation to that point, I was at a meeting last week at which Mr Swinney talked about responsible taxation. KPMG, one of the major accountancy firms, is promoting that approach. One of the topics for discussion at the dinner was the joy of tax. As Professor Beath implies, one way of approaching the issue may be to find behaviours that encourage people to feel that it is not appropriate to go in for elaborate tax avoidance schemes.

**The Convener:** It did not happen to be some bloke with long, straggly hair and an unkempt beard in this joy of tax seminar, did it?

I will now open up the session for questions from members.

**Mark McDonald (Aberdeen Donside) (SNP):** I want to touch first on the issue of no detriment, which appears in some of the submissions. The RSE submission makes a compelling case, and certainly, on the basis of the evidence that has been received by this committee and by the Devolution (Further Powers) Committee, of which I am a member, it seems that there are a number of interpretations of the no-detriment principle.

The RSE submission states:

"There is a pressing need for a comprehensive and independent analysis of how the principle of 'no detriment' will apply in practice."

I look at the group of learned individuals sitting before us and wonder why that has not yet happened and whether it is something that organisations such as the RSE or others may wish to undertake. Such analysis would be of great benefit to the committees of the Parliament in scrutinising how the principle of no detriment will work in practice.

**Professor Beath:** It is almost certainly a question that is under active consideration in the Institute for Fiscal Studies. That might be the place to look for people who have the full-time expertise.

There are two kinds of no detriment. No detriment 1 is essentially a balanced budget constraint at the aggregate level. Other things remaining equal—that is, if nothing changed when powers were devolved—the total devolved and national budgets should be unchanged. I call that the zero budget condition.

The rather more tricky one is no detriment 2, in which, if there are spillovers, some compensatory mechanism needs to be put in place. Measuring spillovers is one problem and, if we find them, there is the question of how to decide on a compensatory mechanism. It would require a lot of detailed research to identify the spillovers, measure their scale and decide how they should be corrected.

**Professor Bell:** It is the second part of the no detriment principle that causes considerable problems. The University of Stirling, along with the Institute for Fiscal Studies, has made a grant application to the Nuffield Foundation to look at precisely that issue.

I can think of a reasonably complex econometric model for no detriment but I would not have anything like the data necessary to calculate the second, third or fourth-round effects, which could be argued to be part of the full implication under the second type of no detriment. We would like to address that issue and we realise that it is very complex. That is another reason why there is a need for time to allow for a satisfactory solution.

I think that there is a problem, in the sense that some reactions might well be market reactions and we might say that a market's response has caused detriment elsewhere. However, that is how markets operate, so it again seems extremely difficult to draw the lines where detriment starts and finishes.

**Mark McDonald:** I presume that you are saying that one of the difficulties that could be faced is correctly apportioning cause and effect.

**Professor Bell:** Absolutely.

**Mark McDonald:** Because what appears at face value to be a policy decision that leads to a certain outcome may actually be somewhat more complex than that and could lead to difficulties in determining whether detriment has, in fact, been caused.

**Professor Bell:** That is absolutely correct.

**Professor Keating:** It seems to me that there is a narrow definition of detriment and a broad one. The narrow one is changes in taxation expenditure that have a direct implication for the other jurisdiction, most of which are in welfare. For example, there is the nexus of housing policy, which is devolved, and welfare policy, which is reserved—things could be done that increased or reduced the UK welfare bill. There is also a suggestion in some of the papers that there is a complement to detriment, which is benefit: if Scotland does something that benefits the other jurisdiction, it could get something back. For example, if you provide more social housing and reduce the housing benefit bill for the UK Government, then you should be rewarded for that.

We can model those things around public expenditure and direct impacts. There was an argument a few years ago about free personal care for the elderly and the implications for attendance allowance, with the Scottish Government saying that it should get that money back because it had saved the UK Government money. However, it is the broader definition that is really difficult, because it gets us into things such as tax competition. For example, air passenger duty could be cut here and flights could be diverted from Newcastle airport to Edinburgh airport, or fracking could be banned in Scotland and the Treasury would therefore forego revenues that it would have got. All that becomes extremely difficult and it seems to me an excessive interpretation, but some interpretations go that way.

We have looked at other countries and found various instances where detrimental action is not allowed, because there is a triggering mechanism and an intergovernmental conference, or things go to the courts. We have not found a single case anywhere in the world where detriment is allowed but compensation is required. I do not know where that came from, because we have not found an example anywhere of that particular solution being adopted.

**Mark McDonald:** Before I see whether Professor MacDonald wants to contribute, I will pick up on the points that Professor Keating made about the benefit. It has been asked how detriment would be measured. Could it be measured on the basis of decisions being taken that allowed benefits to be accrued in Scotland but not in the

rest of the UK, or vice-versa? Could that be construed as constituting a consequential detriment? Does there need to be a very clear outlining in the fiscal framework of what no detriment would mean and how it would be measured and then addressed? Professor MacDonald might want to lead off on that point.

It strikes me that one of the difficulties is that often some of the data that might be required to determine detriment might not be known for two years or more after the event. How do we compensate for a decision or action that is historical in that respect?

**Professor MacDonald:** Just to reinforce what my colleagues have said, the matter is very complex. We need data and we need to work out counterfactuals, as you said. I am sure that we can do that if we have the data. However, it is not clear at the moment that we have the tools to work out properly the repercussions, which, as you said, could be long lasting. For me, that just underscores what we said earlier, which is that we need time. A year is probably not enough time to get the issues right, because we need reasonably good data and we need to build models. As Professor Bell said, that is an on-going issue for the Institute for Fiscal Studies. That all takes considerable time, and understanding what is going on in the models and data takes more time.

10:30

**Mark McDonald:** Moving on slightly, I note that the issue of tax competition has been raised, and one of the issues that I have been pursuing in a number of evidence-taking sessions is that of the budget processes in the two Administrations. As was demonstrated most starkly with what happened with the land and buildings transaction tax and stamp duty land tax, the approach taken in Scotland is to consult on rates and the budget process, while, at Westminster, the long-standing tradition has been what might be called the rabbit out of the hat approach, in which the chancellor stands up at the dispatch box and produces a tax change that comes into effect at midnight. The evidence that we have received suggests that it is unlikely that that situation will change, but do you foresee that the fiscal framework and the intergovernmental relationships in the background will have to change in order to avoid that kind of approach being taken when more substantial levers of taxation than LBTT or stamp duty are devolved? I wonder whether Professor Bell will lead on that.

**Professor Bell:** There is quite a lot of literature on tax competition where two authorities have the power to set taxes on the same tax base, and the difficulty is the possibility of the general populace being overtaxed as a result of both Governments

trying to extract as much as they can from that base.

However, your question was about the process. This point applies generally to quite a number of things, but it seems to me that there will have to be more intergovernmental co-operation or more formal mechanisms for such co-operation to ensure that we reach a more satisfactory situation. The fact that Mr Swinney will announce the Scottish rate of income tax towards the end of the year and that the UK Government will announce the basic and upper rates of income tax at the time of the budget means that there is a first-mover disadvantage there. The Scottish Government will have put its bid in place, and the UK Government might well just ignore Scotland, given that nine tenths of its revenues will come from the rest of the UK. That might leave the Scottish Government in a difficult position, as happened with the land and buildings transaction tax.

I guess, then, that you will want a mechanism that avoids such a possibility, and it should probably be in the background instead of being something formal. There are sometimes reasons why taxes should be announced and in place by midnight—for example, to maximise tax revenue—but nevertheless there is, again, a need to think through what kind of formal or informal mechanism must be put in place to ensure not necessarily that tax competition is minimised but that both Governments have an understanding of the likely overall amount of tax that is going to be taken out of the pool of taxable income.

**Mark McDonald:** Do you wish to comment, Professor Beath?

**Professor Beath:** I have nothing to add.

**Professor Keating:** The literature also highlights the so-called race to the bottom hypothesis, which suggests the possibility of undertaxation as a result of tax competition and as jurisdictions try to attract businesses and wealthy individuals by cutting tax rates. The evidence in that respect is really quite mixed, because it all depends on the circumstances. A lot of this goes on in the United States, where people and businesses are very mobile, and there is quite a lot of evidence of it happening in Switzerland. Because Switzerland is a small place and so the distances that are involved in relocation are fairly short, people can live in one place and work in another.

It depends on what kind of taxes we are talking about. There is a danger of tax competition in business taxation. Many devolved and federal systems have been trying to harmonise business taxation to avoid that. In Canada, there has been a trend towards trying to equalise business taxation, even while other taxation rates are diverging. Even



in France, which we think of as a very centralised country, local government used to tax businesses, but that has more or less been eliminated to avoid such distortions.

It is less of a problem in personal taxation, although David Bell mentioned the problem of wealthy individuals. Generally speaking, however, that is less of a problem, because people have other reasons for living in a particular place, such as that they work there or have family and other ties to it.

It is least of all a problem when it comes to land and property taxation, because land and property are not easily moveable. That gives me the opportunity to mention something that really belongs in this debate, which is local taxation and property taxation, for which the Parliament already has responsibility. It is an important part of the mix and there are opportunities. I know that a commission is looking at the issue in Scotland at the moment. It has to be taken into consideration when thinking about the broad range of taxes in Scotland. We have income tax, assigned taxes and the minor taxes, but land and property taxation is important as well.

**Mark McDonald:** Professor MacDonald, in your paper you mention what you see as an overemphasis on deficit and debt targets and an underemphasis on economic growth targets. Professor Keating talked about the divergence, if you will, in the political debates and electoral outcomes that were had. It seems as though the electoral preference in England was for a continuation of that deficit and debt discussion, but in Scotland the discussion seemed to be more about economic growth and the use of fiscal powers to grow the economy. Do you see a means by which—with, for example, borrowing and tax powers coming to Scotland—the fiscal framework would allow for those divergent approaches to be taken? I realise that it would not be absolute, but there is potential for different approaches to be taken.

**Professor MacDonald:** Yes, it could, but that potential is available at the moment. One of the things that I was getting at in my comments was that, although deficit reduction is the key focus of macroeconomic policy in the UK at the moment, my concern is how robust the recovery that we are seeing at the moment actually is. My concern is that we are simply returning to a situation where much of the recovery is dependent on private sector consumption and the property market. We should be trying to improve productivity in the UK as a whole but also in Scotland. We have very poor productivity rates at the moment. All the contributing factors to the productivity indicators are poor as well. For example, research and development spend in the UK is lamentable and it

is the same story in Scotland. I am not sure that simply changing the tax structure gives any value added in addressing some of those issues. It is important to have those objectives and then find ways of improving things. There are tools available at the moment that would allow Governments in Scotland and the rest of the UK to do that.

**Mark McDonald:** I guess that the point that I am making is that we are looking at the fiscal framework that is going to be established, and that has the potential to be liberating or constraining, depending on how the rules are drawn up. What do you see as the opportunities for a fiscal framework to allow for that difference of approach to be taken?

**Professor MacDonald:** If you have a broader range of taxes at your disposal, you can trade off one tax against another or one form of spending against other forms of spending. I do not think that there is any magic bullet in tax changes. For example, in terms of poor productivity performance, we know that in the Scottish context there was a preference for diverting funds from higher education units to the university sector, which has perhaps had implications for productivity in Scotland.

There are lots of things that can be done with the current set-up but, at the end of the day, there is no magic bullet in having more tax powers, because you will have to trade off one tax against another, or taxes more generally against spending. It is a very finely balanced mix.

**Professor Bell:** Whatever the framework is, if it is transparent and seen to be stable—an enduring settlement—that in itself may provide business with confidence about investing in Scotland. It is important to provide business with a macro-environment and a taxation environment that it believes to be stable. That is vital, for example, for our financial services industry in the short to medium term. In a sense, that goes a little bit against what we were all saying about taking time to sort this out. However, it may still be worth taking some time to get a stable fiscal framework—one that not only the people of Scotland but the business community believe to be an enduring settlement.

**Professor Keating:** The question with austerity, of course, is about the pace of deficit reduction and whether that should be accelerated or slowed down. Even aside from that, there is a broad issue of principle—whether we want a larger public sector than might be the preference in England. I just put that out as a possibility—the political trends seem to be going in that direction.

As far as the economy is concerned, the evidence seems to be that what matters is not so much the level of public spending but exactly what

it is spent on. We are doing some work in our project, which David Bell is involved in as well, on what kinds of expenditure are productivity enhancing and what kinds are not. We are breaking down public expenditure, addressing the productivity problems and trying to model them so that we can work out what the long-term impact of different forms of spending is and what we will get back by way of economic return.

**Professor Beath:** That makes sense as a research objective. The whole point is to understand what it is that acts as the determinant of productivity. That is what my colleagues have been talking about.

**Richard Baker:** I have just two questions, relating mainly to the speed of implementation. At the beginning of the session, Professor Bell talked about problems with identifying a definition of a Scottish taxpayer. Obviously, one of the arguments about why Smith could move forward expeditiously with proposals on income tax was that that work had been done already, for Calman. The committee has had evidence that work is progressing expeditiously on identifying Scottish taxpayers, but you seem to be saying that there are problems arising in that. Can you give us any more details about what the specific areas of difficulty are?

**Professor Bell:** My understanding, and it is a pretty loose understanding, is that for 95 per cent of Scottish taxpayers there is no problem. It is with the taxpayers who spend time both in Scotland and in the rest of the UK that there may be some doubt. My understanding is—but I could be wrong—that HMRC is still working on this issue. This 5 per cent may matter a lot, because the number of additional-rate taxpayers in Scotland is relatively small but they contribute highly disproportionately to the overall tax bill.

10:45

**Richard Baker:** It might be worth us getting some more evidence from HMRC on that, convener. As Professor Bell underlines, it is an important issue, although it may be overcome within the timescale that has been set out.

We have heard evidence about slowing the process down to allow for a greater basket of taxes to be made available to the Scottish Government, to give it more opportunities to raise funds for public services—Professor Keating mentioned that. Would that not introduce greater complexity? How is that complexity managed in other countries in the European Union? I looked at the evidence that we had from Professor MacDonald on the Basque Country in particular. More taxes are devolved there, but it is a pretty complex arrangement and what the powers mean

in practice seems to be quite narrow. What lessons could Scotland and the UK learn from such examples?

**Professor MacDonald:** The Basque and Navarre experience is often taken to be full fiscal autonomy and it is fair to say that nearly all taxes apart from VAT are devolved. However, if we look at the agreement closely, we see that it is really about tax changes at the margin. It is a highly constrained system.

What the Spanish call the fiscal pressure—which is really just the tax burden—in the devolved areas cannot be very different from that in the rest of Spain so, although the regions have a lot of devolved powers in principle, they cannot use them very much. In other words, there cannot be a slash-and-burn change in tax rates; there can be changes at the margin. If a change in, say, corporation tax is desired, it must be offset with some other tax change because there are also tight borrowing rules.

Having said that, not long ago, I spoke at a conference to the guys who designed the system, who say that it has worked. It has given the Basque Parliament the powers that it has needed to grow the economy relative to that of the rest of Spain. For economists, that is not terribly surprising, given that many economic decisions occur at the margins. In a nutshell, that is what is going on in the Basque Country. Whether that could be replicated in Scotland is unclear.

On your point about complexity, the reason why there are so many constraints in Spain is the complexity. If complete freedom were allowed, the borrowing that the Basque Country would need would be inconsistent with the centre's borrowing, and there would be clear issues with that.

**Professor Keating:** I have also considered the Basque case, read about it and talked to people about it. It is true that the overall burden of taxation there must be consistent with that in the rest of Spain. VAT is theoretically devolved but, under European rules, it cannot vary so, in effect, it is assigned rather than devolved. Half of it is assigned in the rest of Spain as well.

There is a slightly lower rate of corporation tax. That is more a matter of signalling. It is a headline rate that says that the Basque Country is open for business. I do not know that 1 per cent makes that much difference to investment decisions. It annoys other regions of Spain, but saying that the Basque Country is open for business is part of the objective. There is a slightly higher rate of marginal income tax, so the income tax is more progressive, which is compensated for by the slightly lower corporation tax rate.

Everybody who I talk to says that the detailed allowances are what really matters. Like Scotland,

the Basque Country has a big problem of very poor private research and development performance. It has the same industrial structure as us—the old heavy industries that, traditionally, did not invest a lot in research and development—so there is a massive research and development effort that is disproportional to the rest of Spain, and there are a lot of tax credits for research and development.

Taxation policy is also linked to other fields, such as labour market policy and industrial reconversion. Whenever I talk to the Basques about the matter, they tell me that the point is not the headline rates or the overall burden but the detail of how they use the taxation as part of a broader social and economic strategy. It seems to have been fairly successful.

The system is extremely complex because there are four separate authorities: the three Basque provinces plus Navarre. That is for historical reasons that are untouchable. Nobody says that it makes any sense.

I have also talked to businesspeople and the trade unions. The business community likes the idea that the tax authority is close. It is not worried about it and says that it can cope with complexity. It likes the idea that it is in direct dialogue with Government about taxation rather than having to go to Madrid to do things.

The other interesting case is Canada, where there is extensive devolution of taxation. It is not devolution, in fact—it is a federal system so, by right, provinces have extensive income taxes, sales taxes and corporation taxes. The sales tax coexists with a federal value added tax called the goods and services tax. The provinces deal with that in very different ways. In Québec, the authorities have decided to link their sales tax to the federal value added tax; in the other provinces, that has not been done. In Québec, they have decided to de-link their income tax from the federal income tax and to have their own tax regime, whereas the other provinces piggyback on the federal tax regime—people just pay a proportion of their federal taxes to the provincial authorities.

If we look at the details of the possible policy divergence, there is scope for quite a bit of differentiation. Québec is very different from Alberta in its tax structure. Recent evidence suggests that Québec, because of its tax and welfare mix, has been able to resist the tendency to greater social and economic inequality in the rest of Canada. Those might look like marginal differences, but they can make a considerable difference to policy outcomes.

**Malcolm Chisholm:** I, too, was going to ask about the Basque Country, but the point has been comprehensively dealt with. This was covered by

part of Professor MacDonald's paper and by part of his more general discussion on full fiscal autonomy. There has obviously been a lot of discussion about that, and I just wondered whether we could have a little bit more light shed on the matter. Professor MacDonald, in the past, you have spoken about some form of fiscal autonomy—I do not know whether you were advocating it or just describing it—and you have various references to it in your written submission. You state:

“if a more radical form of fiscal devolution were to be adopted, such as full fiscal autonomy, there would still need to be a block grant in the adjustment to FFA.”

Towards the end of your paper, you say that there would also need to be a

“central bank and exchange rate policy.”

Presumably, that means independence. I am just wondering what form of full fiscal autonomy you think may be viable, and what kind you think would be ruled out.

**Professor MacDonald:** Basically, I am saying that I do not think that full fiscal autonomy, with the wholesale devolution of all tax revenue and expenditure, with some premium paid for defence and foreign affairs, is possible short of full independence. That is the point that I was making.

Fiscal autonomy, with a devolution mix along the lines of the Basque Country, perhaps, is feasible. It works in other countries, as we have just heard. The complexity of those systems takes a considerable amount of time to be worked out, however, and it must also be borne in mind—this is often forgotten in the mix—that the United Kingdom is a very different set-up from most other countries. Scotland, as part of that, is a very small open economy, as economists would call it, and that has important implications when we start to consider the very significant price and inflation differentials that exist within monetary unions. In the case of Canada, which Professor Keating has talked about, there are fairly dramatic inflation differentials. As we know, there are also fairly dramatic inflation differentials within the euro area.

If you move away from a system of co-insurance and from a fiscal union, as we have had in the UK, the big issue is how to address those competitiveness changes. For me, as a macroeconomist, that is one of the big things that we have to think about when it comes to any further devolution in the UK context, particularly if we are going closer to a fiscal autonomy solution. The competitiveness changes can be large and persistent, and they can lead to imbalances, which, if you do not have an independent central bank or independent monetary policy, will be persistent and could lead to changes in the tax

base and to a whole host of macroeconomic implications.

There is a lot to address and think about there.

**Malcolm Chisholm:** I was interested in your paragraph about that. You talked about productivity differences, too, which are usually explained in the context of the Balassa-Samuelson hypothesis. I am afraid that I do not know what that is.

We have looked at full fiscal autonomy, although I would imagine that that is not going to happen any time soon, and you would probably argue that it cannot happen at all, except within a constrained model. Are those inflation and productivity issues important also in the model that we are more likely to get—Smith or Smith plus? If they are, how should we factor them in?

**Professor MacDonald:** Yes, they are there. They are important and, as we have seen elsewhere, they can cumulate into big differences.

It is especially tricky in the context of monetary union, where you have inflation targeting, which is what we have at the moment. It is quite simple to demonstrate in a simple economic model that your competitiveness—that is basically your relative inflation—becomes quite volatile, and that volatility is bad news for business, because business likes a relatively stable cost base and does not like volatility and uncertainty. Given that Scotland is a small open economy with a lot of capital and labour mobility, it would be very easy for the movement of capital and labour to undo fiscal changes that may be made by the Scottish Parliament. There is huge complexity here and it is very important that the price or inflation issue is thought about and addressed, especially in the context of an inflation targeting central bank.

**Malcolm Chisholm:** Presumably a devolved Government—particularly one with more powers—could take significant action to address productivity.

**Professor MacDonald:** Yes, indeed. There are measures that could be taken now to address productivity. Balassa-Samuelson, which is one of the better-known explanations for price differences within monetary unions, says that if you are successful in creating divergence of productivity—which, in a sense, is what the devolution of powers is about, in that you want divergence and you want to be different from your partners—that will have further implications for the price differences that I am talking about and for the competitiveness of your trading sector.

**Malcolm Chisholm:** Could you be a bit more concrete about that? You are saying that if we succeeded in raising the rate of productivity in

Scotland, that would have negative as well as positive consequences.

**Professor MacDonald:** Yes, potentially. It can have effects on prices and competitiveness, depending on how the productivity works through. Economists have various channels through which competitiveness works. If it goes through the service sector or the tradeable goods sector, it can have different implications.

One of the big empirical or stylised facts is that if you do have improved productivity—in your tradeable sector, say—that will often be transferred through to your non-traded or service sector, which can increase the prices of all goods in your economy relative to your trading partners. Although, on the face of it, productivity is a good thing, it can have important implications for your competitiveness, which need to be thought through in a macroeconomic context.

**Malcolm Chisholm:** It certainly seems that it will take a bit to deal with Smith, to factor all that in.

**John Mason:** We have this phrase “an enduring settlement”, which, if I am not mistaken, is the UK Government’s phrase. Is it so important to have an enduring settlement, which means that something is fixed for the next 25 or 50 years? Presumably, the alternative is a more fluid settlement, in which we keep looking at things and revising them. If we have 50 per cent of assigned VAT revenues, for example, that might do us for a few years, and then we might look at 75 per cent or 40 per cent. It would be a more moveable feast. Would that be possible or is that not a good thing?

**Professor Beath:** I guess that you are looking at me because I said “enduring settlement” in my introductory remarks. What one is looking for is the right amount of stability so that business can plan properly and consumers can make sensible decisions about long-term investment in housing, education or whatever. It would be wrong to think that what one means by an enduring settlement is things chiselled in stone. As we know, those tend not to be terribly enduring.

What one is looking for is a system that can adapt to change, because of course there can be substantial external forces at work that mean that you need to rethink the way you organise things. I would not want to think that what we are setting in place here is a kind of constitution for all time; that would be a dreadful mistake. We should have a constitution that is solid, so that people feel that they know their rights and so on, but as things change, we can rethink the constitution.

11:00

**John Mason:** Would you go as far as saying that maybe we should set a time limit, so that we could look again at Barnett, or whatever the formula is, and the powers every 10 or 15 years, say? Is that too fixed?

**Professor Beath:** It depends on the strength of the winds that are buffeting you. If you decided to plot a course in a boat for 10 years across some endless ocean and halfway across suddenly the winds change, it may not make sense to keep on your course. What you need is a sensible sort of flexibility in your constitutional structures that allows you to say, "Things have changed sufficiently that we do need to think about the way we organise things."

**John Mason:** Professor Bell, you are nodding at that, although you were arguing earlier that business likes to know where we are going. How do we tie the two points together?

**Professor Bell:** As I said earlier, it is important that the major stakeholders in the economy are in a position where they can make long-term plans. The fulfilment of long-term plans and investment in infrastructure such as factories are the sort of things that enhance productivity and lead to higher living standards. You do not want a situation where business is uncertain because the tax regime might change at a moment's notice, given the effect that that might have on willingness to invest.

I am not trying to row back. As Professor Beath said, I do not think that having something set in stone is the answer. You have to have something that has the confidence of the key stakeholders in the economy, whether that be consumers, producers or other levels of government, that if there are changes, they will not disrupt the plans to enhance Scotland's productivity and general improvement in its economic conditions.

**Professor Keating:** I have to recognise the reality that a lot of this is driven by politics; that is part of the democratic process. Change is often incremental. There has to be a certain flexibility, but we need a degree of stability and consistency. The trend internationally has been to introduce incremental change—bits and pieces here and there—and then occasionally take a pause and ask, "What have we produced here?" They are going through that at the moment in Spain, where they have had the revision of all their separate statutes of autonomy. They have revised taxes and bits and pieces here and there and have produced something that is pretty incoherent and dysfunctional, so they are having to sit down and think through how it all adds up. At some point, with the changes going on in Wales, Northern

Ireland and eventually in England, we will have to sit down and think how it all fits together.

The situation is that we do not have a political consensus on the end point. We are not going to have it, because there are people who want independence and people who do not. That is just a fact, and both of those are legitimate points of view. We have to live with that, but we do not even have agreement on what the questions and the fundamental issues are, never mind the answers. It would be useful to pause and think about what the fundamental issues are that we disagree about and what the basis of the debate is before rushing into sorting out very detailed aspects of the settlement. That is where Smith went wrong—it went straight to the details to see what we would concede, rather than thinking, "What are the main issues at stake here and do we disagree about what the principles should be?"

I think that the political conjuncture at the moment is such that we have a couple of years to think the issues through. It was impossible to do that, maybe, in the last legislature or the run-up to the referendum, but now we have that opportunity.

**John Mason:** Did you want to say anything, Professor MacDonald?

**Professor MacDonald:** No, I have no further comments.

**John Mason:** Another area that we have talked about is intergovernmental relations, and the suggestion that there should be more of a structure and perhaps something slightly more independent—an arbiter or something like that. I just wonder whether there is any advantage for the UK Government in having different intergovernmental relations. At the moment it can basically impose anything that it wants. Why would it want to have a more fair, open and transparent system? Is there any advantage for it in that?

**Professor Beath:** I think that that is a question for a political scientist.

**John Mason:** I was not aiming the question at anyone in particular.

**Professor Keating:** I have always been very suspicious of the proliferation of intergovernmental committees, joint ministerial committees and committees for this, that and the other thing. They do not have very much to do and people do not attend them.

I would be very parsimonious in terms of what intergovernmental mechanisms we need. I have suggested three: one is on Europe, which we already have, and another is on welfare. The third is on finance—a mechanism on that really does matter because we know that the UK Treasury has a very centralist mentality, which is an obstacle to thinking about devolution generally. However, I

presume that it would be in the Treasury's interests to have some kind of stability—to know the rules of the game. It is important to have a forum where such things can be discussed and debated. There are political aspects, of course—these things are matters of politics, but other matters can be debated. It is also important that there are, somewhere within the intergovernmental machinery, independent sources of information so that at least we have a common database on which to base arguments about territorial distribution of finance.

**John Mason:** Would the final decision still be with the Treasury, or should we be removing that facility?

**Professor Keating:** The removal of that facility is critical. There has been a lot of talk about federalism in recent months—federalism is the answer. In a proper federal system, the central Government would not be allowed to make the decisions unilaterally. That is what makes federalism different from devolution. The difficulty with getting to federalism is that it is difficult to do it just for three parts of the UK. There should a statutory formula that can be revised, and there should be some certainty in the outcome so that both sides know the rules and what their basic entitlements are. Decision making simply being done unilaterally by the Treasury is not federalism in any meaningful sense.

**John Mason:** I want to touch on the Scottish Fiscal Commission. It concerns me that although we are a relatively small country with 5 million people, we are trying to copy things that are going on either in the United States, which has 300 million people, or in the UK, which has 50 million people. I believe that one of the advantages that we have in being a smaller country is that we can do things more simply.

I think that I pick up from your written submissions a suggestion that the Scottish Fiscal Commission should do its own forecasts, but we also have the Government doing forecasts—it worries me that there may be duplication. I think that Professor MacDonald used the words “overseeing the forecasts”, which I thought was interesting because it might mean that the Scottish Fiscal Commission does not do forecasting itself but audits or looks over the forecasts.

We talked earlier about independence. Audit Scotland is—I think—seen as being independent and trustworthy, but it does not do things itself; it just checks up on others. Is it important that the Scottish Fiscal Commission does the forecasts or will it be okay as long as it is checking them?

**Professor Beath:** Let us suppose that the commission just checks. What would happen? The commission would essentially say, for example,

that if you make this assumption and that assumption, and if this parameter is this amount and that parameter is that amount, this is the number that you get, so the calculations are correct. It would just be checking that the arithmetic was right.

We are thinking about a rather more robust mechanism, in which the commission would say, for example, that it does not think that an assumption is right, or that evidence suggests that a given parameter in some relationship is a different number. That is the kind of independence that is looked for; that is proper refereeing.

**Professor MacDonald:** I agree with John Beath. John Mason made a good point about doing this as economically and efficiently as possible; there is no point in reinventing the wheel. There are different ways of setting up a forecasting model, and the point that Professor Beath is making is that the assumptions that are used could affect the outcomes from the model. Even an independent commission might find it difficult to scrutinise someone else's model and really get to grips with what is going on.

**John Mason:** Is that a question of resources more than the relationship between organisations?

**Professor MacDonald:** Yes—it probably is to do with resources. It may be that the Scottish Government has a different agenda to the Scottish Fiscal Commission. I think that independent scrutiny would be helpful. It would also be possible to buy in forecasts, perhaps from the OBR, which might be more effective.

**John Mason:** Going back to the Audit Scotland model, that organisation seems to be able to dig quite deep and to challenge Government and anyone else fully. It is often really quite hard hitting. That seems to be a good model.

**Professor MacDonald:** I agree. I wonder, however, whether it would have the skill set to understand, say, the econometric model that the Scottish Government is using. It could perhaps hire a specialist team to do that.

John Mason raised a valid point about the commission not repeating what other units are doing; it may well be more efficient for the commission to buy and use independent forecasts from the OBR if we want them.

**Professor Bell:** We have discussed that before. Audit Scotland's role is retrospective; what we are talking about is a prospective role.

**John Mason:** I am not suggesting that Audit Scotland do it, but that we copy its model.

**Professor Bell:** The committee has argued in the past for linking up such activity; I do not see a problem in that.

I will pick up on the remarks about forecasting. I have in the past been involved with forecasting models. Inspecting what someone has done differs massively from running a model 100 or 200 times to fine tune it to ensure that everything agrees with the best evidence that can be assembled. There is always an argument for having forecasting capability; where it is sited may not matter too much.

It is also important to caution against what is known as the herd instinct. Even using quite different models, forecasters tend, as if by magic, to come up with quite similar forecasts. In 2008, for example, that was really rather problematic. The whole area has to be thought through pretty carefully.

**John Mason:** Is there any way to stop the herd instinct?

**Professor Bell:** You could ask people to explain their method of forecasting. One of the big issues in the past few years has been what is called mean reversion. We discuss productivity a lot. Many of the UK models tend to deal with cyclical ups and down, but revert to a situation in which productivity is growing at about 2 per cent per year. Over the last six years, that has been hopeless. Whoever is involved with this activity should not necessarily be tied to a methodology that has not served us well in the past.

11:15

There is one final thing to mention on the subject. One might want to consider how the activity is carried out in Ireland—and Scotland is actually larger than Ireland. The Economic and Social Research Institute—the ESRI—in Dublin does a lot of this kind of work; it might be worth speaking to the director of the institute, Alan Barrett, about its role and how it interacts with the Irish Government.

**Gavin Brown:** Do panellists wish to share with us the extent of borrowing powers that they think will be required during implementation of the Smith report, as opposed to the borrowing powers that we get under Calman? Do you have firm views on what would be optimal levels of borrowing?

**Professor MacDonald:** I will first mention something that follows on from the previous question. The more accurate the forecasts, the better. You have to have a buffer for borrowing in the event of bad forecasts. If the forecasting unit is repeatedly poor, you will have a big buffer for borrowing purposes, just to cover bad forecasts. That point is worth bearing in mind.

Are you referring, behind your question, to whether there are enough borrowing powers under Smith relative to Calman?

**Gavin Brown:** Some people suggest that the borrowing powers that would come via Calman are not sufficient. The Smith commission proposals are obviously far greater than Calman, so the borrowing powers would automatically have to be greater. It is a matter of working that out. Should we have no limits whatsoever? Should there be caps for revenue and capital? Is there an optimal model of appropriate borrowing powers?

**Professor MacDonald:** I am not sure that there is an optimal model. I certainly do not think that you could have unfettered borrowing in the open market, which some people have suggested. The Canadians do that, and it has led to a lot of indiscipline in borrowing, which has affected the premium that some of the federal provinces there pay on their borrowing. I would not recommend market borrowing. Constraints will be important; other countries have pretty strong constraints on borrowing. To go back to the Basque experience, there are fairly dramatic strictures and limits there on borrowing.

The short answer is yes—you would need more borrowing than would be available under Calman, but there is no magic formula for the amount of borrowing.

**Gavin Brown:** Do other panellists have different views?

**Professor Bell:** I think I did a calculation about that. If the Scottish income tax revenues were subject to the same unexpected decline as happened to UK tax revenues in 2009, that forecast error would have been around £500 million under the Smith proposals. There is certainly a case for more borrowing to cover such situations. However, that was probably the best example of a complete forecasting SNAFU, certainly this century and probably in the last century, too.

Borrowing by the Scottish Government will count against the UK's borrowing total, so as Professor MacDonald said, it is likely to be constrained. The UK Government will not want excessive borrowing by the Scottish Government to lead to, say, an increase in the rates on UK debt. The question whether that will be a detriment is interesting because interest costs around £70 billion a year at the moment, so the cost of making good on the detriment of a tiny increase in interest rates could be considerable.

**Gavin Brown:** You mentioned a figure of £500 million in relation to tax income decline in 2008, which was an extreme situation. Were you talking just about income tax? Would the figure have been much larger if you had looked at other taxes?

**Professor Bell:** Yes.

**Gavin Brown:** Are there any other comments on borrowing?

**Professor Keating:** The trend across Europe is for more controls on sub-state borrowing everywhere because they count towards national targets in Europe and the international markets.

**Gavin Brown:** Professor Keating—I want to come back to intergovernmental relations. You are sceptical about setting up too many, and mention the possibility of their being ineffective. Witnesses have criticised the existing machinery. Every witness will tell us that we need a more effective system and will probably say that it needs to be slightly more formal. What specific things must we have in place so that we are not doomed to fail, or must we work it out as we go along?

**Professor Keating:** The things that we have been talking about today to do with finance are absolutely critical for Smith to go forward. The absence of that kind of thing has not mattered too much so far, but if the whole of income tax is to be devolved, it will become critical. I emphasise the need for a common database, or at least shared databases, so that we will not be completely dependent on Treasury databases. There needs to be a forum for political negotiation so that change is not just handed down unilaterally. We also need greater transparency so that the public, this Parliament and the Westminster Parliament can get to grips with the change and can see where the money is actually going.

**Gavin Brown:** We have talked about the Scottish Fiscal Commission in detail. Professor Beath's submission talks about forecasts, which have also been well covered. You also mention the idea that the Fiscal Commission should provide some kind of "strategic commentary", especially on longer-term trends and issues. Will you expand on that?

**Professor Beath:** The working group thought that the expanded Fiscal Commission's role would be not just to look at, critique and comment on what the Government was proposing, and on what would come out of its departmental forecasts; it would also be able to ask whether the Government was taking the right route. It is about asking questions and forcing the Government to say that it is taking a certain route because of reasons A, B, C or D. That would give a more transparent system and it would mean that we could have a more balanced and valuable discussion.

**Gavin Brown:** That is helpful. Thank you.

**Professor Bell:** It is not just about testing the Government and its assumptions; there would also need to be an equivalent to what the OBR does in respect of its fiscal sustainability reports. It should be remembered that the annual fiscal deficit—or

surplus—does not necessarily give a clear perspective on all the liabilities and assets that the Government might face during the next 10 or 20 years. If you are thinking of increasing your borrowing a lot now, what position will you be in during the big bulge of the baby boomers retiring?

Those are the sorts of issues that the committee has dealt with quite a lot in the past. As with the budget process, they are a very clear point of contact between the activities of the committee and those of the fiscal body, whatever it may be.

**Gavin Brown:** Are you saying that, instead of looking only at the forecast period, which would be three or four years, the fiscal body should be looking over several decades at what might happen if things do not change?

**Professor Bell:** Yes. The whole-of-Government accounts, as opposed to the annual profit-and-loss accounts, include all the things that are piling up, such as public sector pensions—the state pension is not actually included in the whole-of-Government accounts. You get a much broader perspective on the things that are likely to impact on finances, as opposed to the cyclical economy-up, economy-down, two-to-three-year effects. Those longer-run effects should act as either encouraging or cautionary in relation to what should be done with taxes in Scotland now because they indicate what finances will be like five years down the road.

**Jean Urquhart:** I want to go back to something that Professor Bell said about business and stakeholder confidence. Over the years, we have had lots of predictions of what will make business nervous, yet in Scotland business has been extraordinarily stable. I grant that we are a nation of small businesses, but during the referendum debate there were lots of shock headlines about businesses leaving, yet when we dug down the reality was quite different.

**Professor Bell:** Business confidence is an extraordinarily difficult thing to get a grasp of. Business in Scotland at the moment is doing well, in the sense that, for example, employment has never been higher. There are 2.3 million people working in Scotland, which is an all-time high, at least in recorded history.

Scotland has also tended to do very well with foreign direct investment; within the UK, it is second only to London. From the data that we have—again, the most recent is 2013—it looks as if Scotland's performance in foreign direct investment is still relatively good. You have to think not just about the businesses that are currently here, but about the businesses that could be here if they thought that the environment was suitable, the tax structure was stable and all the things we have talked about were in their favour.



In the past few months, nothing has changed massively in the Scottish business environment. We have quite a lot of relatively big businesses—Scotland is not a nation of small businesses only—but one of the things that are a little worrying is that relatively few are headquartered in Scotland. Decisions are made dispassionately by businesses, comparing Scotland's competitiveness with that of other parts of the world. The whole macroenvironment comes into that consideration.

There is no evidence that anything has massively changed in the past few months, but we do not really know much about what the environment might have been, because we do not know about the foreign direct investment that did not happen.

11:30

**Jean Urquhart:** Do you agree that some of the issues that scared the horses were not predicted? There were developments to do with interest rates and other circumstances that politicians and economists did not foresee.

**Professor Bell:** There has been a lot of debate about the UK economy and about the Scottish economy, which has pretty much tracked the economy of the UK as a whole over the past five years. There have been various predictions and various surprises. The main surprise related to the recovery in terms of growth and output, and to there being, very surprisingly, much stronger growth and performance in the labour market. There has been a complete flatlining of productivity, which labour economists and industrial economists are struggling to explain—and they have not satisfactorily explained it.

The unexpected recovery has had a very big effect on employment and unemployment in Scotland—more, I suggest, than the political events that have occurred over the past year or so.

**Jean Urquhart:** I return to an earlier point. One of the anxieties relates to the lack of data—we have all referred to that. On timescales, is it now a priority for SNAP and Office for National Statistics figures to be calibrated to show outcomes and so on before final decisions are taken on the Smith proposals, or are we going to take a decision and live with the evidence after the event?

**Professor Bell:** These things cannot be put in place very quickly. If you are looking for data on things that you have not collected data on before, you are also looking at not only where we are now, but the trend over the past five, 10 or 20 years.

Once there is some idea out there of the nature of the powers—treating Smith as a starting point,

perhaps—the best course of action would be to think very carefully about the extra data requirements that a body such as fiscal affairs Scotland would have and put some resource into relevant data collection, jointly with the ONS. The ONS might ask for resources for that, because it is extremely short of resources for carrying out such work. I guess I am saying that, given the nature of the settlement, some kind of committee or whatever should consider the information requirements that are necessary to take that activity forward.

**The Convener:** That concludes questions from committee members. I have a couple more to round us off.

Professor Keating, you said that there appear to be

“more controls on sub-state borrowing”.

The Smith commission recommended that

“Borrowing powers should be ... subject to fiscal rules agreed by the Scottish and UK Governments”.

The UK already has such fiscal rules. Is it feasible for Scotland to have different rules?

**Professor Keating:** I will leave the economic phraseology to my colleagues, but the critical thing in other countries is that the overall level of debt within the state should be within the limits set—in the euro countries, it should be within the euro limits, and other countries are subject to different limits, because there are also limits in the Maastricht treaty. The question is how that is distributed between central Government and local, devolved, territorial Governments, which is a matter of political negotiation.

In Spain, the distribution is done through the fiscal council, which represents the autonomous communities and central Government. It is not unilateral—they have to agree. The central Government has a limit that comes from Brussels that it has to distribute, and the distribution among the autonomous communities is done through that council. Spain has 17 autonomous communities, so it has devolution everywhere. It does not have the asymmetric system. However, that shows that it is possible to do this in a negotiated way rather than in a unilateral, top-down way. In distributing the burden among the different autonomous communities, the fiscal council takes into account the conditions in the different regions—the economic conditions, the accumulated debt, the liabilities and so on. There is a way of working out the distribution, and the target that is given to one region is not necessarily the same as the targets for other regions.

I presume that something like that could be worked out in the UK, because different parts of the UK have quite different circumstances.

However, the important thing is that the distribution has to be negotiated and agreed for the state as a whole.

**The Convener:** It should be negotiated rather than imposed. Professor Beath, do you want to comment?

**Professor Beath:** No—that was a fair comment.

**The Convener:** Professor Bell?

**Professor Bell:** Scotland does not have debt at the moment. That is the current position. Smith did not propose assigning debt and parcelling it out in the way that Professor Keating described, so Scotland does not have a set of fiscal rules, other than not to overspend its budget. We have discussed the small amount of flexibility—end-year flexibility and the various things that replaced it. Scotland has always managed to stick to that rule—that has been its fiscal rule. To explore a different rule might take us even longer than we are thinking about allowing to sort out the tax system, and I suspect that the UK Government would not want to go down that line.

**The Convener:** Professor MacDonald, do you have any views on that?

**Professor MacDonald:** I have nothing to add.

**The Convener:** I have a final question. What would be the implications for the Scottish budget of not having the second no-detriment principle, which is about the results of UK or Scottish Government policy decisions following further devolution?

**Professor Beath:** Sorry—will you repeat the question?

**The Convener:** What would be the implications for the Scottish budget of not having the second no-detriment principle, which is about the results of UK or Scottish Government policy decisions following further devolution? For example, the Scottish Government might do something completely different from the UK Government. The first no-detriment principle is about the devolution of powers per se. I am asking about decisions that are made.

**Professor Beath:** Do you mean if the Scottish Government did something completely novel—

**The Convener:** Yes, indeed.

**Professor Beath:** —and you did not have to worry about the impact elsewhere in the UK? Where would that stop? That would be like giving you unlimited powers, would it not?

**Professor Bell:** It seems to me that, if Scotland did not do much relative to the rest of the UK, the no-detriment principle would not kick in. The issue

is about the extent of the divergence and how far Scotland would go—for example, in doing what the Basques do. If you reduced business rates but increased the top rates of income tax, there would then be a calculation to work out, because there would be relative change. The important thing is really the extent of relative change in terms of tax rates, in the first instance, and tax policies.

**The Convener:** An obvious example is APD, which has been touched on. Newcastle was cited, as it always seems to be. In January, George Osborne more or less said that, as far as he was concerned, a compensatory issue would not be involved, even if there was a detriment, as such, to Newcastle. It is alleged that there would be a detriment, although I do not see why, given that Scottish passengers would just go to Scottish airports rather than travel south. I would have thought that that would be a natural thing in any case, regardless of the current situation. His view was that he would consider that to be non-detrimental. That is why I am asking whether not having the second no-detriment principle would allow much greater flexibility and mean that the Scottish Government, for example, did not have to look over its shoulder all the time and say, “If we do this, we might have to compensate.”

**Professor Keating:** I think that George Osborne was saying that he is relaxed about tax competition because that is consistent with his ideological position. Other parties, such as a Labour councillor, might be more concerned about that. The critical thing is the definition of no detriment. Once we get into tax competition, almost anything could qualify.

I can see a need for something specific around the linkage of welfare benefits, whether it is compensation or simply an intergovernmental mechanism that is triggered to try to resolve the anomaly. However, it seems to me that the broad no-detriment principle is far too large and will get us into all kinds of problems.

**The Convener:** With that, I wind up the session, unless the witnesses have further points that they would like to make on any issue that has been covered—or, indeed, anything that has been omitted.

It has been quite a long session. I thank the witnesses for their contributions and for answering our questions so comprehensively.

*Meeting closed at 11:41.*

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