Scottish Affairs Committee

Oral evidence: Revising Scotland’s Fiscal Framework, HC 660

Wednesday 13 January 2016

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Watch the meeting

Members present: Pete Wishart (Chair); Kirsty Blackman; Mr Christopher Chope; Mr Jim Cunningham; Margaret Ferrier; Chris Law; John Stevenson and Maggie Throup.

Questions 1-64

Witnesses: David Phillips, Senior Research Economist, Direct Tax and Welfare Programme, Institute for Fiscal Studies, and Professor David Heald, Professor of Public Sector Accounting, University of Glasgow, gave evidence.

Q1 Chair: Good afternoon, gentlemen, and welcome to the Scottish Affairs Committee and the first evidence session in the look at the fiscal framework. We are very grateful to both of you for attending this afternoon to kick things off. You are two respected academics who have taken a great deal of interest in the fiscal framework and have written extensively on the subject. Mr Phillips, we understand that you have a sore throat and are not particularly in great fettle today and a bit under the weather.

David Phillips: Indeed, so that could be a mixed blessing for the Committee. I will talk a bit less than usual.

Q2 Chair: Please make yourself as comfortable as you can and the Committee understands fully that you are suffering a little bit today, and we wish you all the best in your recovery and hope that whatever medication you are taking kicks in during the course of this session. As normal, if you just want to introduce yourself for the record and if there are any opening remarks that you want to make to the Committee please feel free to do so. We will start with Professor Heald.

Professor Heald: I am Professor David Heald of the University of Glasgow. I have been involved in these issues for a very long time. I proposed what became the “tartan tax” in 1976 and I gave the Barnett formula its name in 1980, so this is familiar ground.

David Phillips: My name is David Phillips. I am a senior research economist at the IFS. I led our work on the Scottish independence referendum. I have been working on this for a lot shorter time than Professor Heald but I have tried to get into the ins and outs of the
Barnett formula and, in particular, the operation of the fiscal framework, the block grant adjustments. That is an area I have done a lot of research on with colleagues at Stirling University.

**Q3 Chair:** I am grateful to both of you for those opening statements. Let’s get right down to the heart of all this. The fiscal framework is an essential part of any agreement we have in the Scotland Bill and it was set out in principles according to the Smith commission. There has been great debate and we are going to get into issues of the block grant adjustment and some of the no detriment clauses in the course of the questions that we have available to you this afternoon. What I want basically from both of you, just as a way of an opening question, is: is it possible to create this fiscal framework that satisfies all the principles that are set out in the Smith commission? We will start with you Professor Heald.

**Professor Heald:** Probably not. One of the points I would make is that there is a massive difference between the Calman commission, where the Muscatelli expert group did very thorough work before the Calman report was done, and the Smith commission. The latter commission was just a political fix after the referendum and the position is that there are strong political commitments to do certain things—the whole of income tax was devolved without thinking about what that implied in terms of a loss of Treasury interest in the Scottish tax base and there has been no thinking about the implications of the assignment of VAT revenues.

The political criteria that Smith has to meet clash with what might have been done if there had been more forethought about what the issues are. We are now coming late to what the technical difficulties are, which is what you are obviously going to talk about.

**Q4 Chair:** What you are suggesting to this Committee, therefore, is we had the political fix of Smith that suggested a number of ways that we should proceed in terms of the further devolution commitments, and this whole exercise is a matter of trying to desperately catch up to the principles of agreeing Smith. Would that be a rough characterisation?

**Professor Heald:** That is not far from being true. The point is that in Scotland there is an assumption that more tax powers mean more spend, also on the welfare area. There has been a great pressure after the referendum for Scotland to get more tax powers but without thinking about the practicalities of how they would work. If Scotland were an independent country it would have full control of its taxes and spend, but if Scotland is not an independent country it is not obvious that it is in Scotland’s interest to take the fiscal risk from some UK taxes but not from others.

**Q5 Chair:** I did not think we would get to this question early in the session but I will put it anyway because it is important, just from what you said in your opening statements there. Is that therefore possible?

**Professor Heald:** Within the context of the United Kingdom, which is a very strange animal, things are possible but they are never going to be perfect. One of the things about Barnett is that all the times I have studied it, that formula and the Barnett squeeze was seen in the Scottish psyche as being extremely damaging to Scotland, but there has been a reversal and protecting Barnett is now seen as a good thing in Scotland.
The UK is a very strange animal. There are four countries but one country constitutes 84% of the population. There is enormous geopolitical change and economic change towards the south-east of England and London. Scotland has done relatively well in the recent past. Certainly the north of England and the industrial midlands have suffered very badly from deindustrialisation in the 1980s.

I am very suspicious of some of the economic incentivisation arguments. At the margin the Scottish Government can make the economy work better, the Aberdeenshire Council and Inverclyde Council can make their local economies work better, but there are very big forces at play. In Scotland now the significant forces are what is happening in the oil and gas sector and the damage to the Edinburgh financial sector after the 2008 crash. On a smaller scale, we have the issue of floods. The question is: if you are part of a state, who carries the risk?

Q6 Chair: That is something we want to explore during the course of this session but can I come put the initial question to Mr Phillips? Is it possible to meet all the principles set out in the Smith agreement in a fiscal framework that is workable between the UK and the Smith agreement?

David Phillips: I will start off with somewhat of a defence of Smith. I think Professor Heald is right in that they were not able to consider the ins and outs of the fiscal framework as part of their plans but given the timescale and the political imperative they had, they clearly did think about the principles they might want the system to satisfy.

Where the issue is—and it has been highlighted in my work with Professor Bell and some other people as well—is whether these principles are all consistent with each other. Principle 1 is that the Barnett formula stays and principle 2 is that you should have a simple and understandable system that does not require constant ongoing negotiations. The two main no detriment principles are in conflict with each other. You cannot design a system that satisfies the spirit of the first principle, which is that Scotland should not be made worse off or better off by the decision to devolve.

If you thought about it, just in year 1 it is possible to do that, but the spirit of that implies more than just year 1. If you design a system that is expected to lead a detriment not in year 1 but in year 2, 3, 4, 5, you are not satisfying the spirit of that first no detriment principle. The systems that satisfy that principle are not fully consistent with the second redemption principle, the idea that tax changes in the rest of the UK should not have implications for Scotland, and that there should be compensation for these knock-on effects.

So there are some inconsistencies in the system and you cannot present a system that satisfies all of these perfectly. The question comes down to what principles do you want to prioritise.

Q7 Chair: Given that there is this wide range of principles, particularly around the no detriment qualities that are included in the Smith outline of principles, are there any that you think it particularly important that they are met? Are there any that you see particularly challenging to meet? Are there some of these principles that we should just neglect and forget about?
**David Phillips:** I am not sure there are any you want to completely forget but there are ones you might want to prioritise. For instance, in the paper I did with David Bell we look at different versions of adjusting the block grant and in all the versions we do take the initial block grant adjustment and then index it over time in some way to what happens to revenues in the rest of the UK or equivalent welfare spending in the rest of the UK, depending on what part you are looking at. But we suggest clearly that can be done. One is based on the per capita percentage revenue growth, one is based on the aggregate percentage revenue growth, and one is based on the population share of the revenue growth, which is similar to Barnett.

**Chair:** We will come to that. We have detailed questions on those issues.

**David Phillips:** Yes. What I was going to say was that when you compare what happens to these—all of these methods satisfy to some extent the two no detriment principles. They satisfy the principle that if revenues go up in the rest of the UK, in each of those methods you have taken a bit more off for the Scottish block grant and Scotland does better or worse depending on whether its revenues do better or worse than the rest of the UK. The question becomes: how do you judge that better or worse? Given that Scottish revenues start off lower than the rest of the UK, if you use the percentage per capita indexation that says that Scottish revenue has to go up at the same rate per person. If you go up by 5% per person in England, the Scottish revenue is going to go up by 5% per person in order to not suffer detriment under the devolution.

**Q8 Chair:** We are starting to get into the indices issue, which is particularly important. We do want to spend a bit of time discussing that properly with you.

**Professor Heald:** Could I come in on the principles question? By far the most important principle is there should be greater transparency about the way the system works. There is lots of misunderstanding about how Barnett works. The documentation about Barnett has never been fully in the public domain. The Treasury has spent 25 years deliberately misunderstanding parliamentary questions and freedom of information requests asking for comparable expenditure in England that drives the changes in the Scottish block, comparable expenditure in England that drives changes in the Welsh block, which is different, and comparable changes in Great Britain that drives the Northern Ireland block.

You cannot run this system with devolved Parliaments and Assemblies under different political control in the same way as if it was part of the single UK Government. So transparency is more important than almost anything else. One of the questions is about whether the system is fair but nobody can make a judgment about whether it is fair unless we have transparent information. The Treasury is perfectly aware of the kind of information it should put in the public domain but it has chosen not to do so.

**Q9 Chair:** I understand that both of you gave evidence to the House of Lords inquiry. One of the things that they said in their report—one of the recommendations—was that the principle of fairness throughout the UK was one that was almost impossible to meet. I do not know if that is something you said or whether that is something you would agree with, or do you have any views on that at all?

**David Phillips:** The principle of fairness?
Chair: Fairness throughout the UK for tax purposes.

David Phillips: It depends very much on how you define—it comes under definitions of fairness. One definition of fairness in the context of further tax devolution would be what the first no detriment principle of Smith says: if you devolve the tax power there should be no expected detriment. If Scottish revenues perform as in line with the rest of the UK there should be no detriment to Scotland; it should neither gain nor lose. What that would imply is that any existing redistribution under the system continues to go on in future because you are building that into the baseline. That is one definition of fairness.

Another one is that once you devolve a tax of Scotland, going forward it would be unfair if revenues continue to be transferred from that tax raised in England to Scotland.

The point I would make is that because we have not had a discussion about to what degree there should be redistribution across the UK, to what degree there should be risk sharing across the UK, it is very hard to have a discussion about fairness because what you mean by fairness does depend on how much you think there should be in terms of redistribution and insurance across the UK.

I would say at this stage it is impossible to think about what would be fair to the whole of the UK because we have not had a discussion about what that fairness means.

Q10 Chair: I think both of you have said in your various evidences and things I have seen written about your comments on this is that the first year is relatively easy to consider in terms of the block grant adjustment because you both felt that it would be completely transparent and all the stats would be available to do this. There will be indices and tricky issues to try to determine and you have rightly highlighted a number of the indices that are being considered.

Professor Heald: Could I just interrupt and qualify that? Where Scotland’s revenue share of the UK tax is reasonably stable over a period of years, the choice of base year is not very important. But we obviously live in very unstable times.

Chair: I know that again there is a conversation been had about the baseline that is going to be used for this in terms of year one. I know that Chris Law has a question on this, as has Christopher Chope, so we will come to both of them.

Q11 Chris Law: I have been looking at the principle of no detriment and about how tax does vary from year to year and it can be a moving feast. I note that the UK Government’s command paper said that you should assess tax receipts over several years. When tax and spending powers are devolved, how should the initial baseline adjustment to the block grant be calculated so that the process is seen to be fair and transparent, which is what you brought up as the No. 1 principle?

Professor Heald: Where the Scottish share of UK income tax is reasonably stable there is not a problem. Clearly because of what is happening to the oil sector and the financial sector one cannot assume that when the data for the current financial year become available that it is going to be stable. That is obviously a political judgment about how many years you take. I do not have a view.

One point I would make is that given the much higher profile of these issues, there was the case either when the Barnett system was introduced in 1981-1982 or when devolution came in
in 1999, that one needed some system of periodic review. I do not think you can say that there is one right method because, for example, the data sources are not necessarily very good.

One of the things I have learnt about the UK Government is the UK Government collects statistics when they serve a polity purpose. In the tax system, where one had a very centralised system, the amount of attention that went into collecting regional subnational statistics was obviously not as high as it would be in a policy where this is a very important matter.

I do not have access to the detailed numbers to hand but I was just coming in to make the point that even on the initial deduction, one has to be careful because the state of the economy and where you are in the economic cycle and particular big events can make a difference.

**Q12 Chris Law:** You talk about having a periodic review. Given the changes in the last 12 months, for example, how frequent should that review likely to be?

**Professor Heald:** When I said review, I meant review of how the system is working. There is almost an analogy with utility regulation where when nationalised industries in the utility sector were privatised, the Conservative Government went to a system of RPI-X regulation, which became increasingly complicated as time went on. But what was built into that was the view that you could not set a formula that would last for all time because there were too many contingent factors that you could not anticipate.

**Q13 Mr Chope:** I apologise, first, that I cannot stay throughout the evidence session because I have another meeting. Within the month we should have this fiscal framework agreement; do you think this agreement will be sufficiently precise that it will not be capable of different interpretations? Do you see there is a danger that if the agreement is not precise, so that different people can interpret it in different ways, which is a traditional way of dealing with such issues at the United Nations and in the European Union, it will be a recipe for litigation?

**Professor Heald:** I am not sure about litigation but the point I would make is that politicians will be politicians and it will be very surprising if Governments did not try to spin agreements to their own audiences. One of the big questions is whether people want the system to work, because one of the things that the system could be used for is to pay Scotland back for having the cheek to have a referendum on independence.

Alternatively, it could be that the Scottish Government might view it as creating another grievance, which can give another justification for another referendum at some point in the future.

Even in well-established federal states like Canada and Australia there are big disputes about how the system works. One should expect that. A polity that is going to have a significant level of decentralised government is going to have to get used to political fights. But the big question is whether people want the system to survive. I suspect there will be sufficient flaws in what is agreed and sufficient ambiguities that if people want to destabilise the system, they will be able to do so.

**David Phillips:** I would hope that the agreement would be precise enough that we know the broad parameters of what is agreed. Some of the sticking points are around how the borrowing powers would be structured—will it be based on seven fixed limits or will it be some kind of credential regime—and around the block grant adjustment mechanism.
Exactly which mechanism will they use for this indexation? We might come on to that later in this session.

I would hope that those things will be agreed and there will be precision on that respect, but even if you have agreement on those aspects that does not necessarily mean that there is no scope for disagreement at all. When we said in our paper, and others have said, the first-year adjustment is less problematic, it is less problematic in principle because you know what you are trying to do. You are trying to take off an amount equal to the revenues they are going to get, so there is no detriment in the first year, but estimating that can be quite difficult.

One of the things we saw with the devolution of stamp duty was that there was a huge difference in what the Scottish Government forecast was going to be raised from it and what the UK forecast. We are talking about 20% difference in revenues. There will be smaller differences in terms of income tax—that is a more stable and much bigger forecast tax base—but there could be differences on what that would be. You then have to have at some point later a reconciliation that says, “We estimated it will be £10 billion; actually it was £11 billion. We are going to make an adjustment later on”. I can see two points of disagreement there. If you have big disagreements on the estimates you initially make, there could be arguments over what adjustment to make there. Then when it comes to reconciliation that could give another chance to say, “We did better because we grew the economy more quickly” or, “We did better because we handled the enforcement better this year. We should keep some of this extra revenue”.

There will still be scope for disagreement even if the principles are precisely defined based on the implementation of it.

Q14 Mr Chope: So you are forecasting a recipe for continuing conflict.

David Phillips: The system will have potential to create conflict. Professor Heald’s point about whether this will be stable or not, whether it will work or not, depends on political goodwill is ultimately key. If everyone wants to maintain their system and keep it working and keep the Union functioning, people will argue but they will come to some sort of agreement and a fudge. However, if there is not that goodwill, it could be used by either side to trade political points, whether that is on the unionist side or on the nationalist side.

Professor Heald: There are two levels to your question. One of them is about whether people agree what the rules are. That is one thing. But the problem is we are in an uncertain world and nobody knows what the actual numbers in five years’ time will be under a particular set of rules. One ought to distinguish that. When Parliaments get to consider the fiscal framework, they should look at the question about whether the rules are sufficiently precisely written that people are not going to play games afterwards about what the rules mean. But what we have to recognise is what the effect of those rules, including indexation arrangements, is going to have. People do not know, not least because we do not know the future paths of the economy.

There are many big things like China and Brexit; there are all sorts of things way beyond the powers of the Scottish Government that might well have a differential effect across the UK.
Q15 Mr Chope: Surely part of responsibility is to take responsibility for those unknowns and for the risks. If the Scottish Government does not wish to take responsibility for that, it does not have to. But if it signs up to an agreement where they do take that responsibility we could get a situation where they will then be blaming the consequences of that upon the rest of the Union.

David Phillips: Can I come in on this question? That is an interesting question because it relates to a missing element in the Smith commission’s discussion about the fiscal framework. The Smith commission was quite precise on several areas where it thought the balance of risks and rewards should lie. It said the UK Government should continue to be responsible for shocks that hit the whole of the UK—so global financial crisis or recession that hits all of the UK—and they should bear the risk and the reward of UK Government policy decisions. They change tax, so they change enforcement of UK taxes. It also said that the Scottish Government should bear the full risk and rewards of their own policy decision, so they have a policy that grows the economy more quickly or gets better enforcement.

What the Smith commission never talked about was who should bear the risk of exogenous shocks that hit only Scotland. For instance, if you thought about the oil price shock, that is nothing to do with Scottish policy but it is an exogenous thing that affects Scotland. The Smith commission never said what should be done about those shocks. The system that has been designed, in effect, says that we are going to devolve Scotland, the risk and reward to you on policies but also the risk and reward of shocks hitting Scotland differentially to the rest of the UK.

That may be a good thing because you might think Scotland needs to be more fiscally responsible, it wants to have additional responsibility and you need to take these responsibilities on. But you might also think that the UK is about a kind of sharing union and there should be some insurance across the UK. By having this quick-fix solution, “Here is some stuff we need to devolve and here is a system to devolve it”, we have not had this debate about how much there should be of this residual risk-sharing across the UK. Other countries have systems where you devolve tax powers but you still have some kind of risk-sharing across the country because, for instance, you will offset 50% of the effect of differential tax-based growth in your country because we will assume some of it is because of your performance but some of it is due to things not under your control and we will protect you from some of these things. We have not had that debate in the UK, and it is high time that we do.

If I could continue, I know I said I had a very sore voice and I am rambling on, but the Ibuprofen has kicked in now.

On your question on the base year and how that matters and whether you tick several years or not, this comes down to what kind of risks you think are affecting base year comparisons. If you think the base year has been hit by a temporary shock, a shock that affects one or two years and is going to dissipate, you do want to smooth out over several years before that shock as well, so that you are not building the impact of that shock permanently into the block grant adjustment.

Q16 Chair: I am not sure if that is absolutely correct. A lot of the debate has been about risk and rewards of undertaking this exercise, and I think that some of the stuff we saw in the House of Lords economic report, for example, particularly the evidence from Lord Darling,
suggested that this is something that was a feature of what was being agreed in the fiscal framework. I am quite surprised that you think there has not been much of a conversation about risk and rewards underpinning this process.

David Phillips: There has been discussion about risk and reward for Scottish policy decisions but not a huge amount of discussion about risk and reward from other exogenous shocks. The reason we chose to analyse the three methods I mentioned for indexing the block grant in our paper, David Bell and I, was because they are the methods that have been highlighted by the Scottish Government and by the UK Government as methods that are being considered. All those methods do give as close to possible full risk and reward to Scotland on Scottish policy decisions, which is what the Smith commission said it should, but it also gives full risk and reward from other exogenous shocks hitting Scotland, like oil prices or other things that might only affect Scotland.

The reason I mention this is because there was this talk about reassessing at some point if Scotland gets hurt down the line, do we need to reassess and say, “Scotland is doing badly and we need to compensate them”? That discussion is almost predicated on this idea there should be some form of insurance that the Smith commission and the ideas that are being talked about to implement it say will not be offered. That is why we need to have this bigger debate about what they should.

Professor Heald: Could I just come back to Mr Chope’s question?

Chair: I know that Christopher has to go; have you anything else that you want to ask?

Mr Chope: If I could listen to the Professor’s answer to my question.

Professor Heald: Your question was predicated upon the fact that Scotland actually had economic levers. I do not agree that Scotland has the relevant economic levers. Monetary policy is a UK decision; the fiscal stance is a UK decision; Scotland will have income tax and assigned share of VAT. Crucial taxes and policy decision are at a UK level. If Scotland was independent, Scotland would take the full risks and rewards of being an independent country. When Scotland is part of the UK, and UK policy inevitably dominates, I think one has to be very careful in not overstating this risks and rewards point. It is one thing taking the risk if you have the policy instruments to mitigate the risks, and in my view Scotland does not have them.

Q17 Mr Chope: This whole fiscal responsibility area and the framework is a policy built on sand?

Professor Heald: There is an element of illusion in what has been said. People seem to have the idea that if the Scottish Parliament notionally funds a much higher proportion of its spend, it would be more fiscally responsible, but the crucial point is fiscal accountability at the margin. Is it credible that one can use the tax powers that one has? Having for 40 years been arguing for fiscal devolution, what increasingly worries me is that there is a danger that the tax powers look big but in practice are made unusable. One of the things that I have expressed concern about before is that the Scottish Government has to notify the Treasury by 30 November about what the Scottish income tax rate will be. There is nothing to stop the UK Chancellor messing that up at the end of March. The Scottish Government might then respond with a comparable move, but Scotland would then have to
pay HMRC to adjust people’s tax codes, and you can imagine what the media coverage of that would be. The UK Government have such enormous advantages in the political game, and if there is not goodwill on both sides it is probably difficult to make any system of fiscal devolution work now.

Chair: I think we will have to leave that at that, if that is okay. Thank you. Chris Law, do you want to come back and submit a question?

Q18 Chris Law: You have addressed quite a lot of my next question. A good example of that lack of political goodwill was during the devolution of the stamp duty land tax in 2012, where in the 2014 autumn statement the UK Government was looking to reform that very tax but did not say so publicly during the devolution of it. What is to stop similar issues like this affecting the current issues of devolution or ongoing, because that is obviously a grave concern?

Professor Heald: Yes, I have used precisely the same example when I have been giving evidence to a Holyrood Committee. I found that very deeply disturbing. The Scottish Government tried to have a revenue neutral change. They moved from the ludicrous slab system to a graduated rate, which I approved of, on a revenue neutral basis. If you wanted an example of sensible tax policy making, my memory is that all 129 Scottish MPs voted for it, which is quite astonishing. Then the policy was to some extent undermined by what was done. The Treasury can say that they were thinking of doing it, but they seem to have been thinking of doing it for a very long time. The Scottish Government ought to be quite pleased that the UK Government follows a good practice, but the timing issue was extremely damaging.

Q19 Chair: I recall your raising this, and I think it is an important question that has been raised by Mr Law, and it is worth exploring this a bit further. There is nothing whatsoever to stop the UK Government behaving like this again, which would have a further impact on any ability of the Scottish Government to manoeuvre on issues such as that.

Professor Heald: It becomes a question of whether the Scottish Government and the UK Government wish the Union to survive.

Q20 Chair: There does not seem to be anything that the Scottish Government did in this case.

Professor Heald: No, in that particular instance the fault, in my view, was entirely on the side of the UK Government. The point is, as I said in answer to an earlier question, you have to expect game playing. It would be naïve not to expect that. It happens in all federal countries, but they actually live together eventually. If you want to make a fiscal devolution system work, which Smith wanted to happen, you have to pay attention to that. I argued to the House of Commons Committee on Fixed-term Parliaments that the UK budget ought to be brought forward to November, also following the practice of the devolved Parliaments, and we ought to avoid this problem. You need a degree of budget co-ordination between the Governments.
Q21 Chair: If we have time we will come back to this, because this is a very interesting line of inquiry and I think we have several questions on this. But I think we are eager to get into indices now, and I think this is the key section. I know that both of you have written quite extensively about the various indices that are on offer. What surprises this Committee is the variation and outcomes with the different indices. I know Kirsty Blackman has a series of questions on this.

Kirsty Blackman: I hope you do not mind but I am going to take them out of order from the order that we have in the brief.

Chair: No, absolutely.

Kirsty Blackman: The Smith commission said, and I quote, “Future growth in the reduction to the block grant should be indexed appropriately”. It also said, “Effective operation should not require frequent ongoing negotiation”. We are the Scottish Affairs Committee, and I represent a Scottish constituency, and I would like to ensure that my constituents get a fair deal, just to lay those out to make the context of my questions. The first question I would like you both to answer, relatively briefly if possible, is: which method of block grant adjustment do you each favour and why?

Professor Heald: Anton Muscatelli of the University of Glasgow and David Eiser of the University of Stirling have presentations on the website of the Devolution (Further Powers) Committee at Holyrood.

Chair: We are seeing Professor Muscatelli in our next session.

Professor Heald: It is very obvious the one that is more fiscally neutral is the per capita indexation. The other methods imply, over a long period, very substantial reductions in the Scottish budget. Ever since the Act of Union, Scotland’s population has gone down relative to the population of the UK. One can think of factors that mean that trend is likely to continue: immigration, the geopolitical economic pull of London and the south-east, or other reasons. It is not just Scotland that is affected, because as I said at the beginning of my presentation, the English north and the English midlands are in some ways even worse affected than Scotland. Per capita indexation is the one that—I made the point earlier that I want a periodic review—I think on the basis of the Muscatelli and Eiser modelling does not look as though it would be very much different from neutral over a reasonable time period.

But if I come back to the point that David Phillips made earlier, there is a fine art of interpreting Barnett. One of the things that nobody has mentioned is that one of the reasons some people want rid of Barnett is they think that Scotland gets too good a deal already, so that the question is: does the first detriment principle mean that whatever advantage Scotland has now should be protected or does it mean that the Barnett block adjustment method should continue?

I think the two things that are beneficial about Barnett, which has been rarely defended in recent years, are, first, it keeps the Treasury out of Scotland, out of Wales, and out of Northern Ireland in terms of policy detail. It does not say, “You cannot do that because it is against our policy”. Secondly, it gives the Scottish Government, and in the past the Secretary of State for Scotland, penditure switching discretion and enables the Scottish Government, the Northern Ireland Assembly Government and the Welsh Assembly Government to have a much more corporate view of the needs of their jurisdiction than is
possible in England. Those are crucial benefits. I think if people come before you suggesting a needs assessment, the point to be made to them is, though I expect you will need to—

**Q22 Chair:** Interesting although all that is, and I am sure you are absolutely right that that is a key principle in Smith, that the Barnett must be maintained and preserved. That is almost like a non-negotiable as we go forward in considering these issues. I think that underlines everything we are doing in terms of making progress on the fiscal framework. Kirsty, I know you have other questions.

**Kirsty Blackman:** Yes. Do you want to answer that, David?

**David Phillips:** Yes, I can answer that question. I am going to give you a typical two-handed economist answer and say, “On the one hand while on the other hand”. It again depends on what you think “fair” means here. If you think fairness means, going forward, that any further growth in English tax revenues on income tax should remain in England and should not go to Scotland, and that any changes in tax rates in the rest of the UK should not have knock-on effects to Scotland—the second no detriment principle—then the method you would want to choose would be the levels deduction method. That is where you say, “Scotland gets a population—” you adjust the block grant by a population share of the revenue change in the rest of the UK. That would be fair if you thought that devolution meant Scotland no longer gets a slice of what happens with England tax revenues.

If on the other hand you think that the first no detriment principle, this policy change, should not be about unwinding this level of distribution across the UK, that Scotland does have lower revenues per capita on income tax, and there are some transfers from England and that should continue, and you want a deal that if Scotland’s revenues go up by 5% per person and keep up with England, Scotland should not be worse off, then you would want to choose the per capita indexation method.

I think it comes down to this question of what you perceive as the key issue of fairness here. Is it about Scotland not losing out, that any distribution that is currently going on continues in the future? In that case, you want to have this per capita indexation deduction method. If you think the key to fairness is, “No, they now have these powers devolved, the UK Government no longer have a say over this tax in Scotland and they should bear all the risk of it”, then you want the levels deduction method. The interesting point is that the paper that David Bell, David Eiser and I have shows that the differences that these can make can be really quite substantial over just 10 or 15 years. For instance, over the space of the years between 2000 and 2013, the difference you get between the per capita indexation deduction, the most generous to Scotland, and the levels deduction, the least generous to Scotland, was about £1.5 billion per year by the end of that period. There is quite a substantial difference in the amount you get there.

Another point I would raise is I think sometimes if you draw a graph in the short term—you have the three methods in our paper, per capita growth, aggregate growth, and then the levels deduction, kind of similar to Barnett—you find that aggregate growth lies between the two. You might think, “We can agree on this as a compromise”. In the short term it does kind of lie between the two, and you might think of it as a compromise. In the long term, because that never adjusts for the fact that Scotland’s population is falling, that can become the worst method for Scotland.
Q23 Chair: I think you were going the long way around to say that you think that the per capita indexation is the best.

David Phillips: What I am saying is that the per capita indexation deduction method will be the one that delivers the best outcome for Scotland, and will be the one most likely to maintain the existing level of redistribution through the UK. If you think that is what was meant by the Smith commission, that is the one you would want to choose. If you thought that what the Smith commission was about was saying, “Scotland is bearing the risk of these revenues and it is no longer fair for English revenues to go towards Scotland”, then you would want to choose the levels deduction. Different politicians will have different answers to those questions.

Q24 Kirsty Blackman: In terms of the Barnett formula, how much of the block grant will be determined by Barnett after this, and how much of it will not be determined by Barnett. How much of the money that Scotland gets will be determined by Barnett and how much will not? Do you know?

David Phillips: The notional block grant will still be entirely determined—Barnett determines the change in the block grant each year, not the level of the block grant. How these systems will work is the Barnett formula will continue to go on as it does now, continue to determine the entire block grant, and then there will be this adjustment that sits off on the side and takes a bit off that block grant. So the Barnett formula, in principle, will remain just as important as it is now in determining the underlying level of the block grant. Really then, we come to the question of: what fraction of the budget will be made up of devolved revenues or assigned revenues and what fraction will be made up of the remaining adjusted block grant? I think it is about 50:50.

Q25 Chair: Is that your view, Professor Heald?

Professor Heald: I would not like to guess a number. I think that is a question you should put to the Scottish Government.

Q26 Chair: We will see both the Scottish Government and the UK Government on that. I think that that is a very interesting slice of the pie, and about how you see that developing.

Kirsty Blackman: Moving on. Sorry, I should not have said “block grant” in there; that is not what I was thinking. There is too much new terminology to learn. I am beginning to grasp it. In terms of a fixed-rate adjustment, when the Lords took evidence on this the fixed rate adjustment of a 2% deduction per year was one of the things that was mentioned. How do you feel about the possibility of that?

David Phillips: I think that is a really bad idea. I think there is an even greater chance of a zero-sum game there, because each year you argue out: should there be 2%, 2.5% or 1.5%? I think it is even more prone to political disagreement on a year-by-year basis than if you choose a method that links it to some other factor, some factor you can more easily measure.

Secondly, I think that it would not satisfy one of the principles of the Smith commission, and that was that the UK Government should continue to bear risks that affect the whole of
the UK. Let us imagine that there was a shock; revenues fell by 10% because of a recession. If you index the revenues in the rest of the UK, revenues fall by 10% in Scotland, 10% in the rest of the UK, and you take 10% less of the block grant. Scotland is insulated from the shock that hits the whole of the UK because the block grant goes up to offset the fall in Scotland’s revenues for that temporary shock. On this, if you choose a fixed number every year, the block grant goes up by 2%, as it would have, and Scotland’s revenues have fallen by 10%, and they have fallen by 10% in the rest of the UK, Scotland has to bear that risk of that shock. That will require more borrowing on the part of Scotland, which might be more expensive for Scotland to do and might be difficult. I think that method would not satisfy the Smith commission, and I think it would be more open to disagreements. How do you choose any arbitrary percentage?

Q27 Kirsty Blackman: You have both mentioned risks and rewards, and you have both mentioned the levers that the Scottish Government have. In terms of the economic levers that the Scottish Government have, in terms of changing our population size in Scotland, do you think the Scottish Government have sufficient of those levers to protect themselves against risk, particularly if the UK Government are making decisions that are advantageous to the UK as a whole, perhaps, but not advantageous to Scotland?

Professor Heald: I think there is an economic dynamic going on in the UK way beyond the control of the Scottish Government, and that is the way in which London and the south-east suck skilled labour and people away from other parts.

Q28 Kirsty Blackman: Even with this massive amount of devolution that we are apparently getting, which make us the most powerful devolved nation in the world, are we still going to have these issues?

Professor Heald: The Scottish Government will only control a limited part of Scottish tax revenues. I support income tax devolution, not necessarily the specific scheme, but the principle of income tax devolution. But key taxes like VAT and corporation tax are in the control of the UK Government, and monetary policy and immigration policy is. To some extent this tends to centre around Scotland, but there is a big issue for the UK as a whole. So you get things like talk about the northern powerhouse, for example, but there is a real problem about geographic imbalance within the UK. Given that problem, to say that the Scottish Government should carry all the risks and rewards in terms of income tax revenues, I find that rather implausible, because I do not think the levers are—

Q29 Chair: Can I ask, because I think it is quite important that we examine this, most of the indices, when they are drawn up and assessed and looked at, seem to fall or stand up about demographic trends and relative economic development throughout the United Kingdom. Most of the indices that are applied seem to build that in as a feature in order to try to make sure there is a no detriment principle and that Scotland will be able to sustain risks and rewards. Would that roughly be right, or is there anything else that we are missing out in terms of looking at informing the indices as we move forward and getting a proper fiscal framework in place?

Professor Heald: One of the points about the per capita indexation is it removes the question of relative population size. You can always argue whether it is the Scottish Government’s fault that Scotland’s relative population changes, but it has been happening
for 300 years. The trend has been there for 300 years. It is very clear in the data since the 1801 census. In terms of getting the system to work, if that is what people want, I would argue that Scotland should be protected from that population risk.

**David Phillips:** If I add to that, the important point is when you protect Scotland from a risk on the downside, population risk, by using a per capita indexation method, or kind of a levels deduction delivered with a bit of a lag, you are also stopping Scotland gaining from increases in the revenue that result from increases in the population. For instance, if you had a per capita indexation method and one of the things that Scotland got better at was retaining graduates in Scotland, and that meant the Scottish population went up and, therefore, there were higher tax revenues, that would be partly offset because the population indexation would offset the population element of that. Whenever you try to protect from a risk, you also end up stopping the reward on the same dimension. That is always worth bearing in mind; the risk and reward, incentive and insurance are flipsides of the same coin.

**Professor Heald:** Given my reading of the UK and the experience of the last 300 years, that is a risk I am prepared to take.

**Kirsty Blackman:** That is what I was going to clarify. Professor Heald has been pretty clear that from past experience it seems unlikely that Scottish population is going to increase relative to the UK, particularly at the moment when we are not in control of immigration policy, and we have just been discussing the post-study work visa, which is the subject of our other inquiry on the go at the moment. It is really useful for you to provide this information. Thank you very much.

**Q30 Mr Cunningham:** Have the tax increases in the rest of the UK led to higher spending in reserved areas? Should Scotland be expected to contribute and, if so, how might this be captured by the fiscal framework without it being a source of dispute or grievance.

**David Phillips:** I think Scotland should contribute to those things. Say, for instance, the UK Government put up income tax in the rest of the UK and spend that money on pensions, Scots will gain from higher pensions. The second no detriment principle, the idea that Scots should not gain from tax increases that are imposed in the rest of the UK, would require an offsetting adjustment elsewhere. The way that would work via these block grant adjustments is that income tax would go up in the rest of the UK, that has led to a faster rate of growth in tax revenues in the rest of the UK, you take more off the block grant, and that means, in effect, the Scottish Government’s budget falls. What you could then say is the Scottish Government then have the choice of either saying, “Scots are gaining more in terms of pensions. We are going to put up our own tax similar to the rest of the UK so we can continue to maintain spending on public services” or “We are going to bear the cost in less spent in public services”.

I think that is important for fairness. If more money is being spent on things that benefit Scots, as well as people in the rest of the UK, Scots should make a contribution to that. They had a vote in the UK Government elections, these things have to pass double majorities with the English votes for English laws even, so they have a say in these matters. Will it cause political difficulties? Yes, I think it will, because I am not sure people have grasped these complicated interactions between the no detriment principles, the block grant adjustments, and changes in spending on reserved items. I think pensions
might be less complicated than if it was changes in spending on debt interest or spending on defence. Attitudes to those might differ more between Scotland and the rest of the UK.

Q31 Chair: I am interested in some of the remarks by the Cuthberts in response to some of the things that you have said there. Obviously you are very much aware of their critique of that. I think the example they give is the deficit reduction programme throughout the United Kingdom, which is a political policy decision by the UK Government that perhaps is not supported politically in Scotland as in the end we would bear the costs of all this, in terms of how you have summed this up.

David Phillips: My response to that is it is a reserved matter. You may disagree that there should be reserved matters and that Scotland should have a say on these matters as a separate entity, but given that there is a reserved powers model of devolution, Scotland needs to contribute to these reserved matter things. If Scotland gets outvoted by the rest of the UK on these reserved matters, that is just part of the system we—

Q32 Chair: Scotland is pretty adversely impacted if that was to be the case though, if we were—

David Phillips: But the austerity measures would have a detrimental effect on the rest of the UK as well as Scotland. Unless there was a reserved matter where you thought the impact on Scotland would be significantly worse or significantly less bad than the rest of the UK, I do not—

Q33 Mr Cunningham: Sorry to interrupt you, but is one of the reasons why it is a reserved matter that, at the end of the day, the Treasury may be called upon to underwrite it?

David Phillips: Yes. The overall fiscal stance is a risk borne by the whole of the UK, and it should be a matter decided by the whole of the UK. You can make that point. Going back to the Committee’s question, I think these decisions need to be made for fairness and they fit in with the idea of the reserved powers model. But I am almost certain there will be difficulties around them, because it will be seen as unfair. People will view it as unfair if the Scottish Government’s budget gets cut because the UK Government is spending more on defence, even though I think it is required for fairness, because in my view it would be unfair for the people either in Scotland or in England to benefit from higher taxes being raised on the other.

Q34 Mr Cunningham: Professor, do you have anything to add?

Professor Heald: I will abstain from that argument. What I am puzzled about is, within the UK system, how one knows what a particular tax is used for. If a UK Government changes national insurance or VAT or income tax outside Scotland and says what it is being used for, it is impossible to verify it because it is a single pot in the consolidated fund.

David Phillips: Yes, I would agree completely with that. That is why I think there would be some proposals of whether you could somehow make other adjustments. You could somehow deal with tax spent on reserved matters in some other different way to the normal, standard method for working out the block grant adjustments. I think that is very difficult to do because we do not have this kind of system where revenues truly are
hypothesized for different regions. The Cuthberts in their arguments suggest moving to a much more federal system where you have separate English budgets and English taxes. I think if you wanted to go down that route that is what you would need to do. You would need to move towards a more federal system where you have federal taxes, and then England, Scotland, Wales and Northern Ireland taxes.

Q35 Mr Cunningham: I do not know enough about the Scottish Government, but in my experience when I used to be involved in local government, we used to have negotiations with the Local Government Minister, whoever was responsible at that time, to find out what you were going to get per capita in the coming year. I would envision something like that in relation to these devolved issues for the Scottish Parliament.

David Phillips: In terms of negotiating the block grant amount per year?

Mr Cunningham: I would have thought there would have been some sort of discussion there.

David Phillips: I do not know. That is not traditionally how the system has worked in the UK. The two biggest devolved areas would be welfare and defence, and then I guess debt interest as well. The welfare system, while having a unified system of welfare for the main benefits—

Mr Cunningham: We did not always get what we asked for, but there was obviously discussion about it.

David Phillips: Yes. I do not see negotiation around that being a viable solution, because it is not divvying up money to different areas. Things either benefit the whole of the UK, like defence, or things that have common rules across the whole of the UK. I think you are right in that people will pay a lot more attention to how much of these things go to different parts of the UK in the future.

Q36 John Stevenson: On borrowing, the Smith agreement is clear that they should get increased power to borrow, and you borrow for current expenditure and you borrow for capital expenditure. To what extent should those borrowing powers be granted to the Scottish Government and what rules should be applied to this, do you think?

Professor Heald: Do you want to answer this?

David Phillips: I think you need to distinguish between the current borrowing powers and the capital borrowing powers. You need to distinguish between the current—

Q37 John Stevenson: There should be two policies, effectively?

David Phillips: Yes. I think you should at least initially think about those separately. I think there will need to be substantially increased current borrowing powers, because I think the current borrowing powers under the Scotland Act are not enough. All you can borrow for is for forecast errors. If your forecast error needs to be £10 billion, but you have £9.9 billion, you can borrow that £100 million, but if you actually forecast revenues to drop, you can’t borrow to make up that forecast fall. You have to use your reserves or cut spending to do that. Given that Scotland will be bearing more fiscal risk under a system of
substantially more tax devolution, it needs to be able to borrow to smooth the cycle, not just undo the mistakes that it makes in the forecasts. So I think substantially more borrowing powers will be required there.

In terms of how big they should be, I think one thing that needs to be done is to consider—and David Bell and I are looking at this in the paper that is coming out later this spring—just how much volatility there is in revenues and how that correlates to the volatility in the UK, so actually how much fiscal risk Scotland will be bearing. If you were to do a limited number like 2 billion, 4 billion, 5 billion, it would tell you what that number would have to be. Then there is the question of: do you think there should be a limit at all or should it be up to the Scottish Government to decide a limit based on some sort of prudential kind of framework. I am less clear about what I think should be done there. The prudential framework works reasonably well for capital borrowing for local authorities. I am not sure if it is quite so appropriate for current day-to-day borrowing powers. It has not been trialled for that on local authorities. They can’t borrow for current purposes. There is a question about how this would fit into the UK Government’s management of the overall fiscal framework for the UK as a whole.

On capital expenditure, I think there may be a stronger case for a prudential borrowing regime. However, there are some differences with local government. In effect, it comes down to people wanted the system to work. Local government has an incentive to play by the rules because it wants the system to work; it does not want to be bailed out. Central government know that they can always step in and if they think there has been some imprudential borrowing by local authorities they can step in and overrule them. If there was disagreements about whether borrowing was prudential by the Scottish Government I think the politics would be much more difficult. If the UK Government were to grant these powers and then step in and say, “Oh no, we think you’re borrowing too much”, I think that would cause far more political ramifications.

**Q38 John Stevenson:** You think there should be parameters for it?

**David Phillips:** I am saying I am not sure but if I was the UK Government I would be more reluctant to give it.

**Professor Heald:** There have to be limits. Quite how those limits are formulated is a different matter. There have to be limits because the United Kingdom has international obligations.

**Q39 John Stevenson:** It is not who is responsible for the borrowing. It is just at this stage whether there should be limits but you are saying there should be limits?

**Professor Heald:** Yes. I think the reason there should be limits—whether they are negotiated limits or statutory limits is a separate matter—is because Scotland is part of the United Kingdom and its numbers count in fiscal numbers for the UK, there has to be some method by which the UK Government know what the Scottish borrowing is going to be. As David said, if you have tax powers where your revenue is subject to variation of the economic cycle, you very clearly need the current borrowing powers.
Q40 John Stevenson: That is fine. I have established that. Who is responsible for those borrowings? Is it the UK national Government or can it be the Scottish Government? There is an element of moral hazard, which you would understand.

Professor Heald: Economists will tend to take a different split in two camps on that matter. I think that one of the arguments for the Treasury continuing to do the borrowing is that it will be cheaper. Generally speaking, national Governments can borrow cheaper than subnational Governments.

Q41 John Stevenson: What the Scottish Government would be responsible for would be the interest, effectively?

Professor Heald: Yes. There is an incremental interest cost so, looking at it with respect to the UK as a whole, you devolve the actual physical act of borrowing to the devolved Administrations. The contrary argument would be that there would be more fiscal discipline applied if the Scottish Government had to go to the markets itself. There are two issues. One of them is whether you are prepared to incur the additional borrowing costs, which are costs to the UK as a whole, and also whether you believe any claim that there is no bail-out clause. It is very difficult in the context of a country that has been as fiscally centralised as the UK to believe that the UK Treasury would not take fright at the idea of default by a subnational Government.

Q42 John Stevenson: So logic would dictate, if the UK Government is going to ultimately take responsibility for the debt there are undoubtedly going to have to be limits set on both current and capital expenditure?

Professor Heald: I agree with that. The question is those limits on the revenue side have to be quite substantial because of the fluctuation of revenues over the cycle.

Q43 Chair: Just on that, I am looking again at Lord Darling’s evidence to the Economic Affairs Committee, which you are familiar with. He said, “I am part of the UK as well. Do not tell me I cannot be bailed out by a country that I happen to be a citizen of.” Is that not a pretty central principle when it comes to the issue of bail-out and borrowing powers?

David Phillips: I am not entirely sure on that point. For instance, if you look at federal systems, quite often there are no bail-out issues there. If you look at the United States, there are cities that have gone bankrupt that are not bailed out by the central Government. It depends on what you think the social and fiscal contract—it goes back to the point at the start, what risk sharing there should be.

Q44 Chair: The central principles of the vow in Smith, which is the idea of pooling and sharing and taking the risk of—

David Phillips: Yes. If you think there should be pooling and sharing, you may think that you want to have the potential for there to be some kind of bail-out. On the other hand, you might think that the bail-out potential gives rise to skewed incentives for—
Q45 John Stevenson: Would you not agree that if the UK Government is to take responsibility for the debt they are undoubtedly going to want to know what those limits are, otherwise it is illogical?

David Phillips: Yes. I was going to come back to that question. I think what Professor Heald said about the difference between whether in effect the UK Government do a borrowing on behalf of Scotland and then Scotland borrows from the UK Government or Scotland goes directly to the markets themselves does have a role on whether you want there to be fixed limits or whether you want some kind of prudential regime where it is more up to Scotland to decide.

Q46 John Stevenson: But even if Scotland borrowed on its own, ultimately the UK Government are going to have to underwrite that.

David Phillips: The US gives examples of where you have borrowing by subnational Governments that is not underwritten and it is believed not to be underwritten by the central state. In the context of the UK, maybe you will not get fully down that road but just the fact that you can observe—if it was thought that this was being fully underwritten by the UK then what Scotland could borrow on the markets would be the same as what the UK can borrow on the markets. If there is any difference between them, it would mean that there is some degree that they think there is some risk that they will not be fully bailed out. I do think that there would still be more market discipline, as Professor Heald said.

Q47 Chris Law: Around the Smith agreement point on the second principle of no detriment, which is that compensation should be paid, I wanted to ask: is that necessary, who would be responsible for it and how would it be implemented?

David Phillips: I think this is a bit of a can of worms in terms of implementing it as a day-to-day feature of the fiscal framework. Virtually all policies by one government or the other will have knock-on effects on the other. A typical example could be changes in the Scottish rate of income tax. Say the Scottish Government decided to put up the top rate of tax from 45p to 50p, there could be several knock-on effects for the UK Government. People work less in Scotland now because of the higher tax rates so they also pay less national insurance and less VAT, which is at least partly UK taxes. Should the Scottish Government compensate the UK for those losses of revenue? People can shift their income into dividends and take it as dividends income, in which case that is remaining undevolved to Scotland, which is an increase in its revenues. Should the UK Government give those revenues back to Scotland? What if people move from Scotland to England; should there be compensation there? There are often so many complicated behavioural effects that giving estimates of it would be very difficult.

They also interact with the benefit side of things. There are issues around the interaction of benefits. For instance, if the Scottish Government were to offer benefit top-ups and people stay on benefits longer, potentially that could have implications for the UK reserved benefits. I think it might be worthwhile having some principle that where there are significant knock-on effects and they can be easily and demonstrably linked to a particular policy, there is scope sometimes for compensation payments to be made. But that would rely on it being something you can be fairly concrete about, otherwise I think it would just be disagreements and difficulties and it would become unworkable. Having it as a backstop
measure in this somehow may not necessarily be a completely crazy idea, but trying to implement it on every case of a policy decision would quickly become unworkable.

**Q48 Chris Law:** That leads to another question I have: who would implement it and how would it be decided? Should it be an independent body and should there be a minimum level of compensation? How would this be in practice? Is that a political will situation?

**David Phillips:** I think it is. You would want to have some kind of independent arbiter that makes a suggestion, a recommendation, but I am not sure whether they would make the final decision. You tend to find in federal systems where they have these independent bodies to make recommendations about allocations or fiscal issues that they make a recommendation and then that is usually accepted by the two Governments because of the political costs of disagreeing with it, but ultimately the decision is still made by the political agent. In Australia, for instance, the ultimate decisions lie with the federal Treasury. They are the ones that actually make the decision and the UK might need to do that.

**Chair:** Can we move on? We have some questions on some of the welfare measures, which will have a big impact on the arrangements here.

**Q49 Maggie Throup:** You just touched on benefits. I want to expand on that in relation to the fiscal framework. How should the block grant be adjusted to take account of the devolution of spending powers? What are your thoughts on which risks the Scottish Government should bear and which should be they insulated against?

**David Phillips:** I think that in principle the same kind of indexation methods that have been discussed for tax is a good place to start for the welfare measures. That might depend on what your conception of these is, whether you use the levels deduction or the per capita indexation deduction. There has been more discussion at least on the benefits side than the tax side about should we take into account other factors that might affect the differences in needs in Scotland, for instance not just the population changes in Scotland but also say differences in demographic effects or differences in the prevalence of ill health. I think trying to do that would be quite complicated. Suppose you know what the distribution of disability benefits payments by age are in year 1 and you forecast for population growth by age band, you could potentially do an indexation based on this differential ageing of the population, but over time disability benefit by age has changed very substantially. It has come down massively for older people and is going up for younger people and that could have an impact on benefit spending trends in the different countries. You might go further down the line and say that you need to reassess this, and I think it would be even more difficult to try to adjust for the levels of ill health.

One of the incentives you want to give here—again there is a question about how much scope there is for these incentives but at least in principle you want to have incentives to try to reduce ill health in Scotland. One of the arguments for welfare devolution has been that we now get to gain from the fact that if we do better healthcare and better social care we have lower benefit bills. If you start to adjust for the levels of ill health, you remove all those gains from the devolution. I think that none of this is simple but going as simple as possible and trying to do something that is symmetrical that is done on the tax side is probably a good approach. Other more complicated things do not necessarily deliver you
that much in the way of benefits but become more complicated and will require more frequent renegotiation and will blunt some of the incentives over time.

**Professor Heald**: The question of the interconnection of the tax system and the benefit system is not an area that I am expert on but it is one of the areas where I foresee lots of difficulties. Some benefits are done on a net wage basis rather than a gross wage basis and tax changes in Scotland could affect entitlement to UK benefits in either direction. One of the reasons why I think the second detriment principle will have appeared was the controversy quite a long time ago about when Scotland introduced free personal care and the Treasury refused to transfer the attendance allowance money to the Scottish budget for that purpose. That acquired a resonance much bigger than its actual financial significance.

I think I said at the beginning that one of the things that worries me seriously is that in the debates about the Smith commission and about the Scotland Bill there is something of an assumption that having powers over welfare means more welfare spend. That is fine provided you tell me which services in the block, health and education, are going to take the hit or which taxes are going to be put up to pay for it. There is a danger on the welfare side that people attempt to make promises to compensate for UK changes in the benefit system that are implausible. One of the things you must recognise about welfare is that the numbers are very big, very big indeed.

**David Phillips**: Northern Ireland is a case in point on that. They have been struggling very hard to find the resources to undo some of the changes at the UK level and they are big numbers. I agree with that.

You mentioned the point about indexation of welfare and that is very important, but I think Professor Heald’s point there about the interaction between the tax and benefit powers is a key point here. Universal credit that is being rolled out is going to be based on net income assessment. For instance, if the Scottish Government were to cut taxes, that increases people’s net income and they get less universal credit, that saves the UK Government money and that is where the idea of competition comes from. That is one of the examples where you might think it is relatively straightforward to do a first-round effects kind of calculation: you know how much less you see you are paying out and people are paying less tax. The UK Government can transfer that money to Scotland or, if Scotland puts up taxes, vice versa. I think the interaction between these no-detriment principles and benefits is another key area.

**Q50 Maggie Throup**: Talking about interaction between tax and benefits, do you foresee any challenges around the interaction of devolved and reserved benefits once spending powers are devolved?

**David Phillips**: Yes. Sometimes there is passporting of benefits. For instance, depending on what you are entitled to on DLA and PIP has implications for other benefits, things like universal credit and housing benefit. It does become more difficult to think about: if there are substantial reforms to the system in Scotland that change eligibility for these benefits, how does passporting on to the UK benefits then work? That could be a tricky issue going forward. There has been a lot of critique about the stringency of the tests in personal independence payments, the PIP, for instance. You might envisage one change being that the test might be made a bit less strict in Scotland, as they have been trying to do in Northern Ireland by giving more advice to people on how to deal with these tests. If that
was to lead to more people getting PIP, that has knock-on effects for people getting extra UC or extra housing benefit. I do think there will be complexities between these.

Q51 Chair: Thank you. I am just conscious of the time. We have some more questions we want to ask about and one that we have not touched on thus far is VAT, if that is all right, Maggie.

Maggie Throup: Yes, that is fine.

Margaret Ferrier: On the subject of VAT, the Scotland Bill proposes to provide Scotland with the first 10% of standard rate VAT revenue raised in Scotland. The UK Government do not set out in their command paper how the sum will be calculated, including whether it should be addressed at the point of production or consumption. PricewaterhouseCoopers has raised concerns also that the Scottish Government would then bear the risk of any fluctuations or falls in VAT revenue, while having no direct influence in the setting or collection of it. In fact, to quote James Cuthbert, “Overall, it is difficult to see that Scotland gains anything from the proposal to hypothecate to Scotland a share of VAT revenues. Scotland gains absolutely no extra powers but is exposed both to the short term fluctuations and the long run indexation risk, which will be associated with this tax.” The question is what would Scotland gain from assignment of a share of VAT revenues and how should that share be determined?

Professor Heald: I made the point earlier on about the Smith commission being a political fix and wanting more powers. The only argument you can make in favour of VAT assignment in the context of the UK is a supposed psychological benefit that the Scottish Government feels that it is actually spending Scottish money. I am rather dubious about the question of whether you believe in that psychological benefit, but that is the argument for it, “We are spending our own money”. There has been a lot of sensitivity in Scotland about the London media basically arguing that there is a big flow of subsidy coming to Scotland because of the block grant when Scotland is actually contributing to the sources of the block grant. We are where we are. Clearly it was part of the Smith commission proposals. My assumption is that we will have the same kind of indexation system as for income tax.

I am worried about increased complexity. Barnett always used to be regarded as a simple system and we can see increasing complexity in that. I think that is something that is a worry and the question is whether it receives as much attention in the process of settling the fiscal settlement as does the income tax one. One of the things that worries me is the intelligibility of the system. For 30-odd years I have been trying to explain to people how Barnett worked, not always with great success, and it is interesting that even the House of Lords Economic Affairs Committee does not seem to understand that Barnett drives comparable expenditure. It has virtually nothing to do with identifiable expenditure except that comparable expenditure is part of identifiable expenditure. Even with the present relatively simple system, there is huge public misunderstanding of the system.

Q52 John Stevenson: Am I correct in saying that the proposal, therefore, is the UK collects X amount through VAT and Scotland gets a percentage of that?

Professor Heald: Scotland gets a deduction from the block grant based on estimated VAT in Scotland.
Q53  **John Stevenson:** It is not the VAT that is collected in Scotland?

  **Professor Heald:** It depends what you mean by “collected”, because that is the administrative procedure with HMRC.

Q54  **John Stevenson:** Yes, but there is quite a significant difference. If it is linked to the VAT that is collected in Scotland and they get 10% of that then there is an incentive for Scotland to do certain things to attract business into Scotland that spends money that raises VAT. If it is just getting a percentage of the take nationally then there is no incentive to do anything.

  **David Phillips:** There will be half of an estimated Scottish share of—

  **John Stevenson:** My point being, it is an estimate. It is not the actual amount that is physically raised in Scotland.

  **David Phillips:** This is the point I would come on to now, if I can, and answer Margaret Ferrier’s question. Can I answer that?

One of the subpoints of your question was about what does Scotland gain from these powers. I am not sure I would be quite as negative as Professor Heald was. In principle the idea behind tax assignment is that if you do not have the powers over the tax itself, you get to keep and lose marginal revenues and that means you have greater accountability, greater incentives to grow the economy because you get more revenues. The question then is: do you have enough power to make that kind of win and lose on the policy risk side worthwhile because of the risks around other things affecting revenues, like the oil shock or declines in the Scottish economy or other things? That comes back to the point that we have not had a discussion in this debate about how different risks lie. I think that while there are gains, potentially there are costs.

In terms of how would you go about doing this, I think that is a particularly tricky issue with VAT. With income tax there is a quite well set-up system of identifying Scottish income taxpayers. It could be gamed maybe but there is a well-defined method because you can identify where individuals live, at least in principle. The way the VAT system works is not set up to do that. Tesco does not set up in its accounts how much VAT is coming from each individual store. It might be there in the background in its own detailed accounts somewhere but what it reports to the tax authorities is just an overall amount for the VAT it has to pay. GERS estimates and HMRC estimates of how much VAT is raised in Scotland have been based on surveys and aggregate economic statistics. It is based on looking at household expenditure surveys and on the share of gross value added in Scotland. The household survey jumps around from year to year because of sampling variation. There probably are quite good links between household spending and gross value added to VAT revenues but they are not exact. Again, if there is scope for differences in opinion about these things, having a method that is not very exact probably increases that scope for disagreement.

How do you solve this? I think the only way you can solve it is trying to move towards a system of separate accounting where you do ask firms to separately account for Scottish transactions and rest of the UK transactions and that is very complicated. Something is being considered on that for corporation tax in Northern Ireland but in corporation tax there is a more traditional way of doing that. I am also not sure whether that system would
fit in with the EU rules about how VAT works because it is meant to be a national tax. It still leaves the question about how do you define it as Scottish in the first place: is it based on point of sale or is it based on where the customer lives? How it traditionally works cross-border internationally is business to business is based on where the customer is, business as consumer is based on where the seller is.

**Q55 Chair:** There are also some issues about e-commerce and international—

*David Phillips:* E-commerce is an issue as well, particularly in the US.

*Professor Heald:* Could I just come in?

**Chair:** Briefly, yes.

*Professor Heald:* The point I would make is that HMRC and ONS have had no incentives to collect good data and have sufficient sample sizes. A fiscal decentralisation is going to mean that we are going to need better data because it is quite often difficult at regional level and local authority level to get significant results and that leads to the bouncing around that David was talking about.

**Q56 Chris Law:** A final question from me and it is a very broad question really. Given where we are at now with the stages in development and discussion, would either of you like to comment on a preferred vision of how the Smith agreement might be with regards to a fiscal framework? What would you have preferred to see?

*Professor Heald:* I would rather have been in a somewhat different place but given where we are, I think it is essential that the Parliaments are presented with a very clear fiscal framework and there is a proper debate that will be legitimacy generating on both sides of the transaction. Whether it will work will depend critically upon political goodwill to make the system work. As I emphasised before, I think transparency about the numbers is absolutely critical. Things cannot be left to the Treasury publishing things when it wants to. The Treasury decided when it wanted to publish the funding policy document. It started publishing it at the time of every spending review but it has not published it at the time of the spending review in 2013 or 2015, so it is crucial that there is more transparency.

**Q57 Chair:** I want to hold on to this because I have a couple of questions about transparency and the need to revisit the framework as we go forward. I know that it is a requirement of the Smith commission where it recommends that once it has been agreed, its effective operation should not require ongoing negotiation. However, the arrangements should be reviewed periodically to ensure that they continue to be seen as fair, transparent and effective. I know that there is a little bit of conversation, shall we say, between the UKG and Scottish Government about the oversight and transparency that needs to be in place. The Deputy First Minister’s desire is that this does not need to be revisited on an ongoing basis but the Fiscal Commission takes a bigger role in how the transparency is going to be conducted as we go forward. Do you have any views about how we do this, how we manage to secure an arrangement that makes the process as transparent as possible, not revisit it, as intended by Smith, but ensure that any difficulties and any dangerous bits to emerge over the course of the next few years can be corrected.
**Professor Heald:** Something as central to political life in the UK is going to be politically decided at the end of the day, but I think there is a crucial role about the information supplied. The Scottish Fiscal Commission and the Office of Budget Responsibility, I would expect to have a role although, as we discovered with the extra £27 billion that became available in the autumn, even independent budget institutions can be gamed.

**Q58 Chair:** Is your view that this transparency and this arrangement would be made by some sort of combination between the Fiscal Commission of Scotland and the Office for Budget Responsibility in the UK? What model have you in mind when you are looking at this?

**Professor Heald:** In the longer term, I think the UK requires some territorial exchequer board or something like that to take an overview. My view would be that that body did not take decisions but it put the information in the public domain on a regular basis, it vouched for the accuracy of the information, did not allow the Treasury to have the leadership role that it has traditionally had in this area. But ultimately, as with the Commonwealth Grants Commission in Australia, it is going to be a political decision. People will disagree about what constitutes fairness. If there is no transparency, there is no chance of any kind of agreement about whether the system is being implemented fairly.

**Chair:** A few concluding questions. I know Margaret Ferrier has a couple.

**Q59 Margaret Ferrier:** I was not sure that we were going to get to the concluding ones, Chair. There we go. In your opinion, is a fiscal framework likely to provide sufficient flexibility to allow the Scottish Government to take forward a more distinctive fiscal responsibility in Scotland?

**Professor Heald:** I think it depends what you mean by “fiscal responsibility.” There is the point about some people believe that there is a big psychological effect of notionally funding a larger amount on spending. I think that crucially depends on there being a credible capacity to vary taxes. What worries me is, I have always favoured fiscal decentralisation for Scotland but there was always the idea that Scotland at the margin had a choice of funding public services better if it was willing to pay more tax. The issue now is the gap between different conceptions of the roles of the public sector, and the desire of the UK Government to shrink the state makes that gap bigger. The idea you can use the tax powers to fill the gaps left by reductions in UK spending is not plausible.

**David Phillips:** The degree to which Scotland can pursue its own fiscal policy depends on several factors. If you think about the overall fiscal stand for Scotland—can Scotland be less austere—that depends on just what powers are devolved in terms of their borrowing powers. If there are quite limited caps on current or capital borrowing that are big enough to smooth shocks but do not allow you to borrow more in the long term, then you can’t say, “Well, we are going to borrow more and use that to boost spending in the short to medium term”. What happens to borrowing powers is going to have a big impact on the overall macro fiscal stance.

I think there will be real powers to have a somewhat different structure on things like income tax and welfare powers. Scotland will have the power to vary income tax rates, to vary progressivity of the rates structure, to vary the levels of income tax rates, will have similar powers to make changes on benefits and welfare, particularly in the areas that have been fully devolved for Scotland. I think there is scope to make distinctive policy decisions
but as we are living in an increasingly globalised world where differences in policies across states can lead to competition and migration and difficulties, that is going to be constrained to some extent. It would be constrained if Scotland was independent. It will be more constrained if Scotland was not independent because it is getting fewer powers through income tax, for instance. It is not getting powers over VAT, national insurance or corporation tax; it is getting powers over a more limited set of things. It probably is more constrained than it would be under independence but, again, there is always a trade-off: you have more powers, you have more fiscal reward. I guess I am saying, it does have powers to pursue its own agenda in some areas, less than it would under a more devolved system or fully independent system, but the corollary of that is that there is less risk than there would be under those systems as well.

**Professor Heald:** There is a critical issue about the enforcement of the Scottish income tax powers. The role of HMRC is fundamental in this, so that there is a very big political risk that if the implementation in 2016-17\(^1\) of Calman and 2017-18\(^2\) of Smith is not done properly, one is going to get horrendous media coverage that is going to be extremely damaging. A critical priority for the Scottish Government ought to be to put pressure on HMRC to make sure that there is good enforcement and good implementation.

**Q60 Margaret Ferrier:** A final question on the economic performance of Scotland. In your opinion, can the powers in the Scotland Bill lead to an overall improvement in economic performance in Scotland? Will it give us what we need?

**Professor Heald:** I have always been dubious about the argument that fiscal decentralisation in the context of the UK will have a massive effect on economic performance. It may have some effects at the margin. If the Scottish Government performs better, if Scottish local authorities and health bodies perform better, it might have a marginal effect, but the main drivers of economic performance are not held in Scotland. The argument for fiscal decentralisation is much more about fiscal accountability at the margin and actually being able to say to your electorate, “You have a choice between putting tax rates up or cutting spending”. That is essentially what it is about. One has to remember that the UK is a very integrated economy that is geographically very small, so things that you can do in the United States and Canada, for example, because of much greater physical space, are much more difficult to do in the UK.

**David Phillips:** I would largely agree with that. I think the main benefits of greater fiscal devolution are the accountability point, as mentioned, and these incentives on the margin, that it does better align in some ways to do things that can have small effects on growth or on spending needs, and that it gives this choice about, to some extent, more tax, more spending; less tax, less spending. Whether or not there would be big impacts on Scotland’s economy, again I am not sure these powers give scope for huge improvements in the Scottish economy. On the other hand, I am not sure that if there were substantially more powers or a move towards full fiscal autonomy or full independence, that that growth boost would necessarily follow. Getting faster growth is the desire of every politician. Having additional powers does not necessarily give you that extra growth. A lot of the growth potential is not to do with policy, and policies can have negative impacts on growth as well as positive impacts on growth. When thinking about additional powers, whether it is these

\(^1\) *Correction by witness:* Date changed from 2015–16.
\(^2\) *Correction by witness:* Date changed from 2016–17.
ones or further ones, I would not be necessarily thinking that these are ways we can have huge increases in Scotland’s GDP. I would be thinking about it more at the margin and about giving more choice and more accountability for Scots.

**Q61 Margaret Ferrier:** If you look at the moment, Westminster is going to retain 70% of tax receipts, and the same with welfare; we are only going to get 14%. Surely you are not given the full picture, the full package to be able to collect.

**David Phillips:** As I said earlier, when you devolve a full package, you are potentially devolving more upside risk; you are also devolving more downside risk as well. You have to keep in mind that, with additional incentives and the additional scope to boost revenues and boost economic performance, there are also greater costs if you do not boost revenues and do not boost performance. Extra powers are not a one-way ticket to greater prosperity in Scotland; they bring risks as well as rewards.

**Professor Heald:** My big concern is that tax powers might atrophy, like the tartan tax powers did. I wrote an article in 1997 expressing the fear about the tartan tax, which I supported, that it would atrophy, that if you did not use the power when you had it, it would atrophy. One of my fears is that after all this debate, through Calman and Smith, there is a danger that the powers will not be used and will atrophy. That would be a very important lost opportunity.

**Q62 Chair:** Can I ask a couple of closing questions? One is about the process. This will, by necessity, probably have to be Government to Government, and it has been bewildering, even for Members of Parliament who have a great history of interest in this subject. Both the UK and Scottish Governments have talked about mid-February as being the time when this will be concluded. Are you confident, given the number of outstanding issues we still have, that that will be met?

**Professor Heald:** I have no insight into what goes on between the UK Government and the Scottish Government except what I read in the Scottish papers.

**David Phillips:** I think the initial plan was they wanted to have an agreement before Christmas. The fact that it has dragged on longer suggests there are some key sticking points there. The two biggest ones that are likely causing those would be the block grant adjustments and the borrowing powers, because they are the two biggest components of it. Without a better assessment of what should be the risks, rewards, incentives, equalisation, it is a bit of a zero-sum game between the Treasury saying, “We want the best deal for England and Wales” and Scotland saying, “We want the best deal for Scotland”, so there can be tricky issues there. Another point is that even if you have an initial agreement reached between the Scottish Government and the UK Government, that is not necessarily the end of the story because of the legislative consent motion that needs to be passed in the Scottish Parliament. I would not necessarily be surprised if there is some initial agreement between the two but that motion is used to try to get a better deal for Scotland, which would be a logical thing for the Scottish Government to want to do.

**Q63 Chair:** Lastly, given we have started this process and obviously you are interested in this and have done detailed study of what has been progressed in terms of it, do we need to even review how we do finance right across the United Kingdom when it comes to devolved
Governments? I will also ask you this: I think there was an expectation among some sectors of the Scottish public that when there was a No vote in the referendum and how we would move this forward, there was talk about full fiscal autonomy, what was called “devo-max”, which was characterised as meaning everything being devolved other than international relations, defence, foreign policy. Would that have been a much more convenient and useful way to proceed on the basis of what we are doing, given that we have these outstanding difficulties to try to design this fiscal framework?

**Professor Heald:** No, I would not agree with devo-max. I have heard devo-max characterised in terms of the same system as the Government of Ireland Act 1920 whereby the Northern Ireland Government paid an imperial contribution to the UK Government, which quickly became a complete fiction. What I would expect to happen if you had a system of devo-max, quite apart from transferring lots of fiscal risk when monetary policy, for example, is not within the Scottish Government’s control, is that you would get serious conflict and either the system would completely corrode and the system would be manipulated as it was for Northern Ireland or, just as damaging, it would become an argument about how much Scotland wants to pay for Trident or how much Scotland wants to pay for UK defence. So, it transfers the argument. At the moment, the argument is about how generous or ungenerous the welfare state should be in cash and services, and that strikes me as a much more sensible basis for arguments between two tiers of government. If it becomes an argument all about foreign policy and foreign wars and defence and how much Scotland is willing to pay for UK policies it disapproves of, that strikes me as a road to a lot more conflict on a different ground.

**David Phillips:** I also think that full fiscal autonomy would be a bad move. It would not solve the issues around the political difficulties and the implementation difficulties we have with this system. You would have a whole set of different political and implementation issues. At the moment, the main one would be that given where oil revenues are at the moment, there would be this quite large fiscal gap. Either there would need some form of continuing block grant, so Scotland gets to keep all its revenues and have a block grant on top which then comes back to pay for defence and other things, or Scotland gets to keep all its revenues and not contribute to these UK things, otherwise Scotland would have very high borrowing at the moment. It would be bad for Scotland at the moment or could cause these issues around what are we paying for at the UK level.

More generally, though, I think that there would have been benefit of a deeper debate about what the fiscal system should look like in the UK. A debate has been long overdue in the UK. Other countries have systems where there is a properly defined notion of what risks are borne locally, what risks are borne nationally, what degree of equalisation there is. We have not had that debate in the UK. We have had this piecemeal approach and every time you would add on an ad hoc solution to it. We have the Barnett formula; we will add on some tax powers to it; we will add on this block grant adjustment to it. We have not had a debate about how the system should work as a whole and even if we can get agreement on a Smith commission framework, the fiscal framework to agree the Smith commission and get those powers implemented, I think five, 10 years down the line, we will need to have a proper debate about getting a system that is more stable.

**Chair:** We are very grateful to both of you. Mr Phillips, you have done remarkably well, given the condition you described to us when you—

**David Phillips:** The Strepsils and the—
Chair: Well done. We are grateful to you both for your time today. This has been the first session of our inquiry and I think it has been a very useful one. It has provided good background to some of the issues that we are going to have to consider in this Committee. Thank you very much for attending today.