



Treasury Committee

Oral evidence: [Proposals For Further Fiscal and Economic Devolution to Scotland](#), HC 760

Tuesday 4 November 2014

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Members present: Mr Andrew Tyrie (Chair); Steve Baker, Stewart Hosie, Jesse Norman, Teresa Pearce, Mr David Ruffley, John Thurso

Questions 122 - 228

Witnesses: **Dr Angus Armstrong**, Director of Macroeconomic Research, National Institute of Economic and Social Research, and **Professor Alan Trench**, University College London Constitution Unit, gave evidence.

Q122 **Chair:** Thank you very much for coming to give evidence this morning. Can I begin by asking each of you—why don't I begin with Mr Armstrong—do you think that, whatever we devolve on tax, it is essential we do it in conjunction with careful thought about what adjustment should be made on the block grant, and that we should do those two things simultaneously?

Dr Armstrong: Yes, I think there are two parts to that question. Given the devolved spending that Scotland already has, first of all, how do you fund that? That is a combination of: should it be from your own revenues or should it be from the block grant? So those two are taken together. If you adjust the tax mix then that will have a knock-on effect on the exercise of the grant that you would give and also how you structure the grant as well, depending on the tax side. There is also a second effect of: depending on the taxes that you devolve, it also affects whether Scotland has to run a balanced budget, so that is whether it is only a question of funding—that is, grant versus taxes—or whether there is a secondary question, which is: would Scotland need to run a balance of budget? For example, if you had devolved some taxes that were highly cyclical then, in order to mitigate some of the unintended consequences, you might need to think about more borrowing powers for Scotland in order to accommodate that.

To bring the answer to a conclusion, I think there are two parts to the answer. One is, yes, you do have to consider the grants and the taxes together, and the second part is, depending on the tax mixture, you would also need to think about whether Scotland needs

to have greater borrowing power in order to accommodate some of the effects of those taxes.

Q123 Chair: Professor Trench, have you anything to add?

Professor Trench: I haven't. I would entirely agree with that. I think that you have to think about the overall package, first of all, funding for the devolved Government and, if fiscal devolution is part of that, then devolved borrowing powers to enable you to balance the volatility and the tax revenues devolved, even if you devolve the most stable of tax revenues.

Q124 **Steve Baker:** Thinking about this fiscal gap, this fact that Scotland has a big mismatch between spending powers and tax raising powers, what benefits do you say come, in principle, from closing the fiscal gap?

Dr Armstrong: The closer the gap is, that is, the less reliant on the block grant, in principle it means that you have greater attachment to the people who are making the spending decisions. In economics this is called a principal agent problem, so to what extent does the Scottish electorate respond to the agent, which is the Scottish Government acting for it? If it has to go to the UK Government first, then all of those lines of responsibility and reporting become much looser. That is why much more direct accountability should lead to more efficiency in the delivery of the services. That is the theory. Then we have some empirical evidence, which is not particularly good because every country is different. So I would take these surveys and studies with a bit of a pinch of salt, and there are also chronometric problems with them as well, but on the whole it looks like having a smaller gap between the amount of spending you control and the amount of revenues that you raise does lead to a marginal improvement in long-term efficiency. We can argue about the math, and so on.

Q125 **Steve Baker:** If I could pick up on one point before I bring in Professor Trench. You mention the principal agent issue.

Dr Armstrong: Yes.

Steve Baker: There are a range of proposals on the table for the extent to which powers should be devolved, which one of these proposals do you think represents, if any, the boundary between an ineffective agent and an effective agent? To what extent do those proposals need to transfer power before they become an effective means of shifting that principal agent problem?

Dr Armstrong: I think the first part of your question is: what is a reasonable gap for there to be? To what extent do you need to close this? Does it have to be completely closed or closed just a little bit, and so on? Then the next part of the question is: well, what taxes would you change in order to do that? Because all the different taxes have lots of efficiency arguments around them and so on and so forth.

To take the first part of the question, again, if we look at other OECD countries, there are basically two types: the unitary forms of Government and federal Governments. If we look at federal Governments, and we take an average of the OECD six countries that are federal Governments, then it would suggest about a 50:50 split—which is not what we have at the moment—between taxes and grants. That is perhaps slightly less than 50:50, so 60:40. That suggests you have perhaps—and this again very rough numbers—about £10 billion worth of more taxation powers that could be devolved to Scotland to at least bring it in line with the average.

Now, is the average the right benchmark? That is a much more difficult question because, of course, the UK Government is very different to the other Governments. We have a very big financial sector, for example, which requires the Government to have access to taxation resources. But that would be my first cut at the answer. Then the second question is, well, what taxes would you devolve to try to achieve that?

Q126 Steve Baker: Professor Trench, would you like to—

Professor Trench: Yes. First of all, I think it is worth being a little bit careful about the terms we use, because the term “fiscal gap” can mean one of two different things. It can mean a vertical fiscal imbalance, which is the sense I gather you are using here. That is to say the mismatch between the amount of spending responsibilities a Government has and its tax powers. But it can also mean a fiscal deficit. It can also mean an imbalance between the amount of revenues that are available to you from whatever source, and the amounts that are spent.

As far as the fiscal gap in that sense is concerned, I would look at it from a somewhat different point of view to Dr Armstrong. That is partly because I am not an economist. My background is in the study of law and politics. I would look at the advantages as being somewhat different. I would see them as about delivering a more appropriate mix of autonomy and UK-wide equity to that which the present system does, in a way that aligns the financial side of devolution much more closely with the constitutional powers that are now in the hands of devolved Governments. I would see that then as leading to a further benefit of improving devolved overall responsibility as a Government, so that devolved Governments, devolved legislatures, are more fully and clearly accountable to their electors and residents for all that they do, not merely for their distributional decisions.

Q127 Steve Baker: On that point of accountability, we have heard in other sessions about some of the complexities that will arise when it comes to operational matters with tax devolution. To what extent do you think it will be possible for the Scottish Government to blame HMRC for issues of avoidance and failure to collect generally?

Professor Trench: I think that there is scope potentially for there to be blame. I think a good deal depends on how HMRC then approaches the discharge of its responsibilities, and about the nature of the administrative and constitutional position of HMRC if HMRC is going to become a tax collection agency for multiple Governments within the UK. Scotland would appear to be on the cards in the first instance, and of course, there is a Bill currently in the other place regarding tax devolution for Wales and there is an ongoing debate about devolution of corporation tax for Northern Ireland and conceivably other

taxes as well. This will alter the character of HMRC. If it were to remain the sole collecting agency—and I have argued there were some strong reasons for that to be the case—it would also imply that HMRC would need to change the way it operates. Indeed, it would need to become much more fully accountable to devolved legislatures and to devolved Governments, because it would no longer simply be an agency of one Government that happened to do some work on the side for another but it would actually be a principal tax collection agency for multiple Governments.

Steve Baker: Thank you.

Q128 Jesse Norman: Dr Armstrong, you have presented some pretty punchy ideas about what should happen to Scotland on the fiscal side and also in terms of borrowing. Could you talk a little bit about what your proposals are?

Dr Armstrong: Yes. The taxation issues are about the funding mix. That refers to my first answer that essentially looked at what is being proposed about whether Scotland should have fully devolved income tax. We came to the view that that probably was not the best approach to getting a smaller vertical fiscal imbalance, the sort of gap that was mentioned earlier. That is for a number of reasons, not least because if it meant that you then had English MPs deciding English income tax and, because of the size of the English economy, 84% of the UK economy, and the dependence of Scotland on that, the amount of exports, about 40% of GDP is dependent on the rest of the UK, one in five jobs, you would have policy possibly being made in England without Scottish MPs having any say in it at all, which struck us as undemocratic. So that was the first point that a large part of macro policy Scottish MPs would have no say on at all.

The next point was about the efficiency of whether that tax was right, and we looked at it from a stability point of view. Scottish income taxes—well all income taxes rely on the business cycle. Scottish income tax is slightly more volatile than the UK income taxes, and so that would mean that you would have to have much more space for county council borrowing, and then you have the whole issue of fairness. You have a large amount of central government reserved spending, which is important, that income tax is seen as a way of connecting people's decisions to what you get from central government, not least central government plays a very important role as the insurer of last resort. When things go horribly wrong and nobody knows what the next thing is going to be, then you rely on central government, and it has to have taxation authority in order to be able to satisfy its creditors that it can be repaid. So you have to have a significant part of taxes. Income tax is the biggest yielding tax for both Scotland and the rest of the UK. Then we looked at other taxes, but the other—

Q129 Jesse Norman: What about the borrowing side? That is the other thing.

Dr Armstrong: The borrowing side, I think that the way that the current structure is arranged—exactly what Professor Trench was talking about—you need to have responsibility and authority. Responsibility requires you to either succeed or fail and to be held to account for that. At the moment Scotland is given a balanced budget. It has an amount of spending and then you agree the amount of income and it basically has to keep within that envelope. What I would like to see is Scotland make its own decisions, if it

wants to spend more, if it wants to invest more. That is one of the main mechanisms through which devolution leads to better economic performance through investment, but I do not see why it should always have its limits set by HM Treasury. I think it should be allowed to invest in private capital markets. It will have market discipline. You need to have the right infrastructure in place, such as the fiscal watchdog and so on, which needs to be appropriately staffed. Then I think it would be much more accountable and much clearer to the Scottish electorate the job that the Scottish Parliament is doing for it. So I think that they should be allowed to borrow and not have constraints put on it by Westminster, and finally constraints they have a very bad record of working and people tend to take them as an objective rather than a constraint, and then you go straight to the constraint and then start an argument. So do not have one. Let Scotland decide.

Q130 Jesse Norman: Just to be clear, what you seem to be saying is that Scotland should face a hard constraint in terms of how it borrows but not in terms of how it is funded from England, and in terms of insurers it should have a soft budget constraint on that side because of volatility, risk sharing and constitutional matters. Is that right?

Dr Armstrong: I think that the terms “hard and soft budget constraint”, it depends. There are many angles to a budget constraint. It is a little bit of a difficult term. What I am arguing is that you need to have a—

Q131 Jesse Norman: Do it the other way round. They should not be insulated from the effects of their own decisions on the borrowing side.

Dr Armstrong: Correct.

Jesse Norman: But they should be insulated from the effects of their own decisions partially on the fiscal side.

Dr Armstrong: On the fiscal side I would like them not to be insulated, so they should also be able to borrow over the cycle. I would like them as far as possible not to be insulated. To me that is the whole principle of responsibility, but it is also recognising that certain functions are carried out by central government and part of this task of central government is to have some sort of equalisation. So you do need to have an element of it, which is the block grant and the block grant is not an efficient thing.

Q132 Jesse Norman: When we had the IFS in front of us, they testified that an equitable allocation of resources from taxpayers’ money across the devolved nations and England could potentially look very different. In fact, in their view it would look different from the one we have at the moment. You seem to be suggesting an approach in which Scotland continues to benefit from the current arrangements, in terms of its funding, and yet is given a whole series of further borrowing powers for which inevitably the English taxpayer will have to pick up the tab if they fail.

Dr Armstrong: There are two points there. What I have not suggested so far is the current funding: what is the mechanism of the block grant? What is the basis of it? So, should that

be changed? I think there is a reasonable case that that is now out of line with what it was intended for and there is a good case for changing how—

Q133 Jesse Norman: So you support IFS do you, broadly speaking?

Dr Armstrong: I think we should certainly change how the block is run, but I would certainly dispute your second thing that we would inevitably have to bail out Scotland if it was to get into this sort of trouble. I think that is precisely the sort of safeguards you try to put in place. You can never say “never” but this challenge is what the rest of the UK needs to consider if they want the Scottish Government to be responsible for its own decisions.

Q134 Jesse Norman: If I may, Chairman, one final question. So if that is the case you can imagine capital markets demanding an extra premium since it Scottish borrowing. You can imagine reserve requirements changing and so on. What other mechanisms does the English taxpayer have to protect themselves against the possibility of Scottish failure if they do over borrow and then fail to generate the revenues and the credit that goes with that?

Dr Armstrong: You could write it into legislation that the UK would not be able to buy Scottish Government bonds, so that would rule out the central bank being able to buy them. You could make it very clear in the terms and conditions of the bonds that this is absolutely no responsibility of the UK. But you are correct that you could never disprove until after the event, what would be the action of the UK. One thing we can say is that Scotland would not be too big to fail. It is one-tenth the size of the rest of the UK.

Q135 Jesse Norman: Its banking system would be, so if we took that into consideration as well we would all be—

Dr Armstrong: That is a different thing. The banking system will always be covered, as I understand it, because of the reserve power by central government.

Q136 Chair: Have you not answered your own question by saying, “We may have to bail out the banking system”?

Professor Trench: Well, if we—

Chair: In a moment. I just want to clarify this point with Mr Armstrong.

Dr Armstrong: Yes, whether Scotland—

Chair: Therefore, we now know the answer to the question. Yes, we may have to bail out Scotland.

Dr Armstrong: Sir, I would argue that we bailed out the banking system because the repercussions of not doing so would be so great for the UK’s citizens that the banking system had become too big to fail for the UK.

Q137 **Chair:** Do you seriously think it is in the realm of the politically possible to put a Bill through the House of Commons that puts the UK taxpayer as a whole on the line for large increases in borrowing in Scotland, which is held by many are becoming unaffordable?

Dr Armstrong: Are becoming increasingly—

Chair: Non-fundable. That the markets are pushing up the price of the borrowing and then are coming close to concluding are very high risk.

Dr Armstrong: The short answer to that is, yes, as long as Scotland has to borrow from capital markets it will find out what the price is and it will be up to Scotland to strengthen its own fiscal base first. Otherwise it will not be profitable for it to do so.

Q138 **Chair:** What happens in the United States?

Dr Armstrong: The United States is very interesting because most of the states do not have borrowing limits imposed by the Federal Government. They impose their own. Now it did—

Chair: What are those limits?

Dr Armstrong: They choose to have a balanced budget.

Chair: How many states choose to have a balanced budget principle?

Dr Armstrong: I believe about two-thirds.

Chair: I think it is over 40.

Dr Armstrong: Over 40, so that is 40 of 50, three-quarters.

Chair: I did not know we were going to get into this today. It is something I happen to know something about.

Dr Armstrong: What is quite interesting is that it could well be the case that Scotland could do that as well.

Q139 **Chair:** The remainder have been extremely well disciplined too. So they are running a balanced budget there on an annual basis in virtually every state in the United States and have been for decades—

Dr Armstrong: Yes.

Chair: —and you are suggesting that Scotland should not do that?

Dr Armstrong: No. I am saying that Scotland should decide what it does itself.

Q140 **Chair:** Right. I am still unclear now. You are suggesting that Scotland should pass a law forbidding subsequent Scottish Governments from borrowing?

Dr Armstrong: I am saying that the Scottish Parliament should be allowed to decide this for itself, and that is exactly what happens in those 40 states. They are allowed to decide this for themselves, and that way we do not continually run up against the same buffer saying, “Well, the United Kingdom set this limit” or that somehow Scotland is constrained. It would be for itself to make these decisions but, as you quite rightly point out, when you leave it to some central governments in these cases they often decide to have a much more prudent path than might have even been imposed by the central government.

Q141 **Steve Baker:** You mentioned Scottish bonds and the central bank possibly passing a law to forbid the central bank from buying Scottish bonds.

Dr Armstrong: Yes.

Steve Baker: We had the Debt Management Office in and they were pretty clear that the current scale and cost of Government borrowing is fundamentally underpinned by monetary policy. What would be the effect on Scottish borrowing of forbidding the Bank of England from buying Scottish bonds?

Dr Armstrong: It would be high.

Steve Baker: So I think you are explicitly suggesting then that Scotland should be able to make a decision to borrow more in the context of higher borrowing costs in the rest of the UK.

Dr Armstrong: First of all, it is untested. What it would ultimately depend upon is the fiscal sustainability of the Scottish Government, but because—as you quite rightly point out—the ultimate backstop is not there because this is a separate Government, and because of the size of the Scottish bond market. The previous work we have done suggests that Scotland would be borrowing at a higher cost, but it would be useful for budgeting purposes to find out what the true borrowing cost is for Scottish investment.

Q142 **Steve Baker:** If Scotland faced higher borrowing costs—you mentioned the principal agency problem and so on—how would we deal with all these issues of accountability if Scotland was still fundamentally in a different set of circumstances when it came to borrowing? How would we ensure the Scottish Parliament was truly accountable to the Scottish public for tax and spend if borrowing costs were explicitly higher because of measures we had taken?

Dr Armstrong: It would be very observable, if the Scottish Parliament decided to carry out a large investment project, for example, what the cost of that funding is, based on what the market’s perception is. We would have very clear budgetary information for the first time. We would have ratings and you would have a Scottish Government thinking about its borrowing consequences for its long-term financial sustainability. I would argue that it has much better principal agent issues than actually borrowing from the back pocket of the Treasury.

Q143 **Steve Baker:** I suppose I am concerned that they would continue to be a sort of grievance culture. That because the rest of the UK was more advantageously positioned in the market that they would be a grievance culture that would continue.

Dr Armstrong: Because we have central government spending and central government taxation, that is what the Bank of England and all the people of the UK are willing to support for incremental Scottish decisions perhaps for some sort of infrastructure spending and so on. I think it is entirely appropriate that: one it is for Scottish people to decide; and secondly, for Scottish people to fund.

Q144 **Chair:** We had better move on but, before we do, I want to clarify something you have said. You have argued that you want these increased borrowing powers in order to redress the problem of volatility.

Dr Armstrong: So you can either do it for capital or current. Current would be the volatility for the current budget.

Q145 **Chair:** Right. You are also arguing that the costs of borrowing might be high.

Dr Armstrong: Yes.

Chair: Volatility may come about, as you have just implied, as a result of variations in current revenues and spend. So how does that enable you—as you have said now three times I think that giving these borrowing powers will enable us to find out the true cost of Scottish investment.

Dr Armstrong: There are many ways you could do this. You could say that Scotland must borrow from capital markets for its capital budget only, which at the moment is going to be limited, but you could say that is not limited, which would be my preference; that Scotland makes its own decisions for this. For current borrowing you could either say that also has to be through capital markets, and I take your point, which I think is that because that probably has a higher borrowing cost at the time Scotland most needs to borrow, so in a deep recession when the revenues fall down it is going to be particularly expensive and counter this—

Q146 **Chair:** Is this realistic, Dr Armstrong? Is this in the realm of realistic politics?

Dr Armstrong: Many other federal countries do this quite successfully. Whether it is actually in the realism or the realm of the current constitutional way of thinking about Scotland that is not necessary for me but it is certainly what other countries have done.

Chair: We are going to give Professor Trench a chance to say a few things now.

Q147 **John Thurso:** I just want have one question for Dr Armstrong to follow up on those comments. If I have understood correctly what you have said, the core of it is that you are better to trust a properly devolved Scotland to take mature decisions and for that Government to be responsible to its electorate to hold it to them, than to see to put an

artificial constraint in the way, which is liable to have consequences that we cannot foresee. Is that the sum of your argument broadly?

Dr Armstrong: Correct.

Q148 **John Thurso:** Thank you. Can I turn to Professor Trench, please? I want to go on to talk a little bit about the principles that should be underpinning what we are seeking to do and to ask you this: broadly, the principles of good tax policy are fairly clearly understood and pretty widely accepted. Is there a similar level of agreement on the principles that should guide us in respect to how we approach devolution and tax?

Professor Trench: Probably not, simply because devolution as we experience it in the UK is a very unusual phenomenon. We take asymmetry to a remarkable degree because we have very extensive forms of devolution that are each different for Scotland and for Northern Ireland, and a pretty extensive—but not as extensive—form of devolution for Wales, and we have nothing for England for the 84% to 85% that is the bulk of the state. That creates a degree of difficulty. Nonetheless, if we start thinking about the lessons that we can draw from fiscal federalism, from how fiscal devolution has been practised around the world, not always, it has to be said, purely in federal systems. The economic subfield of fiscal federalism is as concerned about local taxation as about what we might call state or regional or provincial government.

We can draw some lessons and one is that you can allocate to the lowest possible level taxes on land, and that causes minimal economical distortion because land is by definition fixed in its place and it does not, therefore, shape economic behaviour because the land is not going to move. You do not move the location of the land because of the tax regime. So land taxes are very good taxes always to have at low levels. You then start looking around at other taxes you can put at lower levels and, broadly speaking, taxes on income are pretty good ones to have or to share between a central or state-wide Government and a subnational or regional Government. The same can be said for sales taxes. Taxes on transactions, by and large, are pretty bad taxes to have at a sub-state level, and that can lead to very significant economic distortions.

Q149 **John Thurso:** Looking at that hierarchy as a first principle, if the goal is for as full a fiscal responsibility for the devolved Governments as is consistent with a strong and practically run United Kingdom but within that construct of a United Kingdom you have devolved Governments that have as full a fiscal responsibility as possible, given the tax that we have on land or are likely to have, we are inevitably going to rely, are we not, for quite a large proportion of the tax that will be required from non-land taxes.

Professor Trench: Indeed.

John Thurso: Therefore you would say that the ones to avoid are all the transactional taxes as much as possible. It is an interesting question as to whether the stamp duty and the land tax are transaction or a land tax. But let's not go there. That is another essay. So we are really looking at income and corporation tax as the areas?

Professor Trench: I looked at this in some detail when I was writing the paper “Funding devo more”, which I published with the Institute for Public Policy Research in January last

year, and, although my ideas have moved on a little bit since then, I very largely stand by what was recommended there. Land taxes—

Q150 John Thurso: If I may, you had eight points in that, all of which I would agree with wholeheartedly, but do you think all of them are practical in the way we are asymmetrically and rather accidentally devolving the United Kingdom?

Professor Trench: What “Funding devo more” was trying to do was to work out a model by which you could sustainably fund devolved Governments within a United Kingdom. I also gave myself the task of trying to work out how you do that in a way that is potentially applicable to Wales and Northern Ireland if they should choose to go down that route, not just limit it to Scotland. One of the problems with much of the work that has been done is that it has been purely focused on Scotland, and I do not think that is an appropriate way to think about a United Kingdom as a whole. But it was thinking about what works for devolved Governments within the UK with the sorts of functions they have. What that paper recommended was the outright devolution of income tax and the assignment of 10 of the current 20 points of VAT—those points not to be changed over time—on the grounds that even though you would not have the power to change economic behaviour through altering the rate of a sales tax like VAT. VAT has a number of characteristics. It is essentially a sales tax, and it would enable devolved Governments to reap the benefits of economic growth and—

Q151 John Thurso: You raise a central point, which is that there are two quite distinct reasons for devolving a tax. One is that you need to fund the expenditure that you have devolved and you are looking to balance that with something that will give the money. The other is that you want the lever on that tax for political purposes, to raise it or lower it to achieve a political outcome. One tax may obviously do both, but you have to objectives, which is that you just need to find the money from somewhere that makes some sense but you also have political objectives. To what extent—if you are looking at VAT—is that simply falling on funding and avoiding the politics?

Professor Trench: I would question whether one is purely talking about taxes as a political lever. Taxes are levers in a number of respects and the economic one I would have thought is at least as important as the political. You may gain a headline by cutting or raising the rate of income tax, but you are able to shape economic behaviour by doing a number of other things as well, and it is not simply the rate and sometimes—indeed, quite often—the economics gets in the way of the politics and vice versa.

That said, the assignment of VAT I think makes sense for a number of reasons. One is that broadly speaking over time it is a growth tax. The second is that in the shorter run it is not a particularly volatile tax, certainly compared with taxes like corporation tax. Corporation tax is a remarkably volatile tax, and that is one of several reasons why I think it is a bad tax to seek to devolve with a single state.

Q152 John Thurso: So you would put corporation tax right at the far end of the things that it could be—

Professor Trench: Indeed, corporation tax—as your Committee will be only too well aware—is a tax on company profit and it is subject to a variety of means of manipulation by accountants and by others acting on behalf of those companies and—

Q153 **John Thurso:** It is also quite a small yield.

Professor Trench: It is quite small yield and it is remarkably easy to evade. It turns out it is also a disproportionately burdensome tax, particularly when it comes to its compliance cost on small business. If you are trying to encourage business growth and business formation, it is a remarkably bad tax to use as a lever for that.

Q154 **John Thurso:** To what extent do you think that successful devolution and, therefore, a more federal United Kingdom, will lead to a degree of automatic hypothecation of taxes, in that it will become the norm to say—for example, nobody has suggested this, which is why I use it as an example—“Right, the purpose of National Insurance is to fund the Health Service and, therefore, it is very easy to say that is how much National Insurance you have in Scotland and you can put it up or down as you choose, and that is your health budget, and ditto in England”, and you just hypothecate it in that way. How much is that likely to be the thrust of policy?

Professor Trench: One is certainly talking about a form of hypothecation if one starts assigning a chunk of value added tax receipts. That is a form of hypothecation. I think beyond that that there becomes a need to think a bit more clearly about what is the purpose of the various taxes that we have and what they are used for, and then to think about that in constitutional terms bearing in mind the division of functions between devolved and UK Governments, at least in relation to Scotland—

Q155 **John Thurso:** Therefore, in looking at what you devolve or how you devolve it, it is back to the point I was making, you have an eye on two things, which is: what is the most effective way of giving the right amount of money so they can get on with it, together with what is the best way to put political accountability into the structure so that it reinforces and assists devolution to be a reality?

Professor Trench: I think I would take issue with both the presumption there that there is a right amount of money to put into the hands of devolved Governments, because a vertical fiscal imbalance of some sort is pretty much ubiquitous around the world. I cannot think of any sub-state Government with a quibble in relation to the Basque country in Spain that actually raises all the revenue that it spends on its own functions. There is always a gap there. Trying to match devolved funding with devolved spending should not be the object of the exercise and it is probably impossible anyway.

So that is one stage of difficulty. The other difficulty that I have—and it is a word I carefully avoided using when Mr Baker asked me his opening question—is the word “accountability”. That has been the guiding hallmark of much of the official thinking about devolution so far, going back to the terms of reference for the Calman Commission in, what, 2007, early 2008. It is a useful criterion but it is not one that is used anywhere else in the world and I think it is rather a limited concept, not least because it is positively

saying all you can do is at the margin. It is not even asking a tough question about where exactly that margin is and how big it is. Remember that we are talking about devolved Governments. We are talking about Governments that have very extensive policy responsibilities already: they are responsible for providing health services, they are responsible for providing education from the age of zero or whenever, through primary, secondary and higher education phases, so very extensive education responsibilities, very extensive environmental responsibilities, considerable transport responsibilities, extensive cultural responsibilities as well.

The Scottish Government is responsible for about 65% to 70% of total public spending in Scotland. This is a big Government. That is at the top end of what sub-state Governments are responsible for around the world. Even the Welsh Government is responsible for about 55% of public spending in Wales. So these are substantial Governments to start with. The idea they should merely be accountable and not constructively responsible strikes me as a fairly limited approach.

Q156 John Thurso: Can I ask Dr Armstrong one question? You have heard the discussion I have been having with Professor Trench. Is there any point that you would like to either agree with or disagree with or do you broadly concur?

Dr Armstrong: I think that in the principles of the taxation I would just emphasise the idea of equity and fairness as well as efficiency. The efficiency arguments are pretty well rehearsed but the idea of equity and fairness, the importance of being seen to be contributing the same as other constituent nations of the United Kingdom to central government services I think is important.

Q157 John Thurso: One of the things we must bear in mind is that connection between the citizen and the person spending the money and raising it, so that they perceive that in a fair manner?

Dr Armstrong: Yes.

John Thurso: Thank you.

Q158 Chair: Just to be clear, am I not right in saying most people agree the Basque country makes a net contribution to Madrid?

Professor Trench: The Basque country's accounts are complicated. The way finance works in the Basque country is that the Basque Government sets and collects all taxes within the Basque country and then makes a contribution to Madrid based on its GDP for shared services. However, that is not all the money that citizens pay from their earnings because of the social security—

Q159 Chair: Yes. I am just asking one very simple aggregate question. I have not seen what I have just said seriously—I have seen that as the accepted view. Is that not the accepted view?

Professor Trench: It is an incomplete view because it does not take account of social security.

Q160 **Chair:** So you think they are net recipients?

Professor Trench: Sorry?

Chair: Is the Basque country a net recipient or a net payer?

Professor Trench: As far as I know it is a net contributor to the—

Chair: Right, that is all I was asking.

Professor Trench: But citizens in the Basque country are also making a payment directly to Madrid for what is called social security, which in fact then covers the cost of running the health service in the Basque country.

Q161 **Chair:** Therefore it was not quite true that all countries are in this position as you put it, was it?

Professor Trench: The Basque country is peculiar because of the position of social security and the health care, which is administered by the regional Government.

Q162 **Chair:** All countries are different but this is a large west European country with a significant part of it making net contributions.

Professor Trench: I did not say that no Governments make net contributions. I said that the system by which a Government is solely responsible for collecting all the money that it spends is pretty much unprecedented.

Q163 **Stewart Hosie:** It is quite a good model, isn't it, to collect all the money and pay a subvention for shared services? On a point of principle that does not seem unreasonable if we are talking about a family of nations, a proper unit, that we would—with perhaps a social security exception—collect everything and simply pay for shared services. In principle it does not seem unreasonable.

Professor Trench: Is that a statement or is that a question?

Stewart Hosie: It was a question.

Professor Trench: You are asking—

Stewart Hosie: It is a philosophical question, not a technical one.

Professor Trench: As a philosophical question, it depends what you think your country is. From a small and nationalist point of view, it is an understandable approach that one might take, particularly if one is from a relatively well off part of the UK. I am not quite sure that it would be embraced enthusiastically by people of similar views from Wales or perhaps even Northern Ireland. The question however is: are you talking about funding an

arrangement not within what on your account would be a very, very distant family indeed, the sort of family where perhaps cousins see each other once a year or once every few years rather than are in a close relationship within the same house. If you are sharing the same house there is usually some sort of financial distribution mechanism that is going to operate within that house, rather than each member of the household keeping everything that they own and simply kicking a small amount into a common pot to pay for the heat and the light, which is essentially what you would be proposing if you were to go down that full fiscal autonomy path.

Q164 Stewart Hosie: It wasn't quite the family arrangement I had in mind, not given the mass relationships between all parts of the people on this island. However, can I stick to the general question just for a moment? You will both be very well aware that there has been a huge amount of thinking—over a very long time, by all sorts of people—about how the Scottish Government does its work, about how it absorbs and takes responsibility for the risk but also has the ability to benefit from the rewards of the decision-making that it takes. Much of that you will know has been based on decisions taken in the UK that would appear to lie counter to the instincts of the people in Scotland and the majority of its elected representatives. Can I check—because I know the words were used earlier—the desire to move on and take responsibility in your mind does not reflect a grievance culture in any way, does it?

Professor Trench: I do not think it reflects a grievance culture. I think that, if it is done properly and effectively, it reflects an attempt to avoid a grievance culture. One of the design problems of the 1998 model of devolution is that it certainly creates scope for a grievance culture that, to a limited extent, I would say I see signs of at present and I see ample scope for getting worse in the future.

Q165 Stewart Hosie: As you say, it can be resolved if we get the design of what comes next right?

Professor Trench: Indeed.

Q166 Stewart Hosie: Yes. Dr Armstrong, on a similar point, you made the point earlier that English decisions on tax-making, for example, whether to be separate English decision-making, could have an impact on Scotland, on purchasing power and so on. But is it not correct that if the Scottish Government goes into maximum devolution or full fiscal freedom, or whatever it is called, with its eyes wide open, again accepting the risks and being able to reap the rewards, then that in and of itself is not a problem. It would be perfectly normal and understandable if tax decisions in England were taken in England and tax decisions in Scotland were taken in Scotland, as long as both sides understood they had to bear the risks as well as accepting the rewards.

Dr Armstrong: That sort of symmetrical answer sounds like perfect common sense but the tricky bit is that it is not a symmetrical union. You have one country that is 10 times bigger than the other. So the potential for one to create what economists call externalities, in other words, side effects that it does not have to take account of that can lead to inefficiencies for the other country. If one could be sure that Scotland would never

consider that to be a problem, and in fact would be completely indifferent to whether their economy is positively or negatively impacted by a decision made by its neighbours, I would find that surprising if they had no view. Certainly, I think the UK would struggle if decisions taken by another country would have such an enormous effect on the UK but it would have no say in it. Most people would like to have that degree of responsibility. It also mitigates some of this, “You know, what we are trying to do here is get more responsibility for Scotland”. If in fact many of the economic developments are taken outside of its hands then it is very hard to see how that is achieved.

Q167 Stewart Hosie: Let me move on to something else. You said it is about borrowing. I understood the argument you were making about removing the restrictions so that the Scottish Government takes the correct level of responsibility, whether it is borrowing or whether it is bond issuance, other than the start-up fees because, bizarrely, we have no history of bond issuance because we cannot and because bond issuance or borrowing generally would be slightly smaller. With those two things out of the way, given that Scotland fiscal’s position for the last 30 years has been relatively better than the UK, and given that the credit rating agencies said—certainly during the referendum—Scotland was likely to have the highest credit score, there is not actually an argument in the medium to long term, is there, to suggest that bond yields or borrowing costs would be any higher than the UK at all.

Dr Armstrong: No, I believe that there are. First of all, the credit rating agencies suggested that on a good case scenario—and of course all of it was contingent on what the currency arrangements would be—it would be a notch or two below the UK. One of them said it could be as high as the UK. The UK is not AAA with all the rating agencies so it is not possible to be the highest. So it was not their view. The next thing is what is it that determines the different spreads between Governments and subnational Governments that issue bonds in the same currency? Oddly enough, many of the fiscal factors have an effect but they are quite small. One of the issues that do have an effect is the size of the country because that affects the liquidity of this market, how easy it is for large investors to move in and move out without moving the prices. That just seems to be something that bigger countries just have this natural advantage. You can have more liquid bond markets for bigger countries. This is the liquidity premium that is discovered in just about every econometric study that looks at it.

Q168 Stewart Hosie: It is interesting because certainly one of the debates that took place in the referendum, and is still pertinent even in the context of a devolve Scotland borrowing, is that the gilt yields for many smaller countries were lower than those of the UK. So while there can be volatility, while the market has to perform its own functions, it is not automatically the case that a smaller nation, a sub-state administrative area, would necessarily have higher borrowing costs. Is that not right?

Dr Armstrong: The difference is that borrowing costs are made up of the creditworthiness of that country plus the expected appreciation or depreciation of the currency. If you are comparing another country with another currency, while you have the expected appreciation or depreciation of that currency to consider as well as the creditworthiness,

which is why you need to look at countries that issue in the same currency to get its credit issue, and presumably Scotland would be issued in sterling.

Stewart Hosie: One could argue—I am going to move on from this, this is not the question I want to ask at all, but one—

Chair: Just briefly, because we have a second session we have to get through and we also have Treasury questions on the floor of the House this morning and—

Stewart Hosie: One could also make the point of course that that removes volatility from the equation as well, which is a net positive. Sorry, a question for Professor Trench—

Chair: I am afraid it will have to be one last question.

Q169 **Stewart Hosie:** It will be. Professor Trench, you were speaking about corporation tax as being at the wrong end of the scale of being a usefully devolved power. Many of us see that as quite a powerful tool, not least just signalling the effect of changing it. Were corporation tax to be devolved to Northern Ireland, the arguments presumably against devolving it to Scotland would disappear like snow off a dyke, wouldn't they?

Professor Trench: I would not say they would disappear but they would be a great deal weaker. Certainly if it were devolved outright to Northern Ireland that might in fact not be the case even if there was some form of devolution. I think one important thing and one difficulty with corporation tax devolution is that to do it in a way that does not create an incentive to brass plating and to shifting corporate transactions, you have to do the sort of approach that is used in Canada and the United States. You provide for different rates of corporation tax to be levied on the profits of companies in different parts of the state according to the proportion of their activity that is there, based usually on payroll. Of course, that then affects the scale of what can be done with it and just how useful a lever it might be.

Stewart Hosie: That is extremely helpful and I am conscious of time. Thank you, Chair.

Chair: I am sorry to perhaps curtail a point you wanted to make. If there are further points you wanted to make in that area, or indeed any other, please do put them on paper to us. We are very interested to receive them, and that goes too for you Dr Armstrong.

Q170 **Mr Ruffley:** Dr Armstrong, we all know that the three major parties in Westminster favour giving Scotland a greater degree of ability to vary progressivity in income tax rates, income tax bands, but you will also know that the Calman Commission thought this could create inefficiencies and, therefore, did not approve of this greater latitude on progressivity. Don't those inefficiencies still obtain?

Dr Armstrong: In short, yes. So the greater scope there is for changing the progressivity will lead to changes in behaviour, and of course the degree to which these diverge is not only good behaviour you can also get avoidance behaviour and complexity. In terms of the change of behaviour, you can look at this in two ways: one is that you should not allocate resources by way of the tax rates lowest. They should be where economically it is most

efficient to do so. So that would be a negative way of looking at it. Alternatively, you could look at it as a way of providing a discipline for the different constituent nations of the UK to actually put taxes down as far as they should be. It could be a better disciplining advice as well. So you can see this in two ways. My view is that the inefficiencies that were pointed out in Calman still exist. The question is: are those inefficiencies so great that the degree of autonomy ought to be overridden? That is an efficiency versus equity call, and I think that is more judgment than any economic model can give you an exact answer to.

Q171 Mr Ruffley: But the point about inefficiencies we seem to have heard less of it since Calman. Is that anything to do with the fact that the personal allowance has been wiped out?

Dr Armstrong: I think that there has been a surprise not only in the progressivity and the inefficiencies there but also the question of devolving the whole of the income tax, a lot of the questions about the inefficiency of that seem to have gone by the wayside in the clamour to do more. The inefficiencies are still there as you change the progressivity. You can look at this as being good in terms of creating a discipline side but then negative in terms of distorting behaviour. I think it is very hard to, as an economist, get to an answer on this because there is a trade off and that depends on a political decision.

Q172 Mr Ruffley: Sure. There is lots of speculation that the Government will wish to devolve corporation tax to the Northern Irish Assembly.

Dr Armstrong: Yes.

Mr Ruffley: In the case of Scotland I recall the answers about the huge volatility of corporation tax revenues, but isn't there a strong argument that if Northern Ireland gets devolution of corporation tax Scotland will want it too and why is Northern Ireland wanting it if there is this problem of volatility?

Dr Armstrong: There is a problem of volatility but there is a problem of whether by being a lower tax region you can attract more resources into your area and, of course, because just over the border in Southern Ireland they have exactly the sort of border effect. So I can understand why Northern Ireland want it but you are quite right it has all the implications for the rest of the UK, and not surprisingly I would imagine that Scotland would be looking at this very carefully. In the context of Scotland I do wonder whether there are not other ways of encouraging better corporate behaviour, such as the employers' side of National Insurance, which is basically a payroll tax that actually has a higher yield, is more stable, and might be a better way of thinking about this. But I accept that if Northern Ireland gets it, the negative consequences of Scotland make it more powerful. I am not sure whether that alone means that Scotland therefore should be allowed it because making the system even more complex and having more differential rates would make it worse—

Mr Ruffley: And potentially greater inefficiencies.

Dr Armstrong: Correct. So I think that this will be unwise. First of all, whether Northern Ireland does it and whether Scotland were to follow suit then I think that would become problematic to an even greater extent.

Q173 **Mr Ruffley:** Problematic. It also follows, doesn't it, from what we have heard that if corporation tax became a devolved tax that it would probably be one way. It would be downwards. That is the working assumption. What effect would that have in principle to the rest of the United Kingdom? What effect would it have?

Dr Armstrong: It depends on if—

Mr Ruffley: Obviously the degree of the cut but, in principle, would there not be a tax competition that the United Kingdom would be letting itself in for if it made corporation tax a devolved tax?

Dr Armstrong: The short answer to that is, yes, and the tax competition is the inefficiency. That is where businesses allocate their plants in accordance with the lowest tax regime rather than where it is economically most efficient. Of course, if you did devolve the corporation tax then you would also be reducing the block grant. It depends in part on how you would reduce the block grant, so there is a way of at least attempting to mitigate some of this but this becomes awfully messy and you add one efficiency on top of another.

Q174 **Mr Ruffley:** A final question, Chairman. Under EU state aid rules, any shortfall in revenues would be a responsibility of the authority, in this case the Scottish Government. Does that not make it quite risky?

Dr Armstrong: On which tax?

Mr Ruffley: Corporation tax.

Dr Armstrong: It would make it quite risky but this would again require you to reconsider the borrowing side. As a general principle, if you are going to have more taxation powers then you do automatically increase the possibility of having shortfalls. It is almost impossible to forecast absolute—

Q175 **Mr Ruffley:** And it would have full fiscal consequences, would it not, if there were to be corporation tax devolution?

Dr Armstrong: Yes, but again if Scotland had borrowing capability then it could mitigate the fiscal consequences of that.

Mr Ruffley: Which goes back to your earlier argument that we were questioning.

Dr Armstrong: It does. So there are two parts to this question, one is how do you fund Scotland's high degree of devolved spending. The second one is should it be tied to a block grant? Finding the rationale for some of these taxes it might want to change and say, "Well, you can partly mitigate this by changing borrowing" that is the second best part of the answer rather than keeping those. I think it is two separate questions.

Mr Ruffley: Quite so. Thank you.

Chair: Thank you very much for coming to give evidence today, both of you. I know that, Professor Trench, you have something further you want to say on this but I am afraid we are out of time because we have another witness that we want to take evidence from. If you could possibly write down what you would have said, we would very much like to see it, and I do apologise that we have not been able to explore all the subjects this morning that some of you may have come wanting to air. But it has been an extremely interesting hour. Thank you very much indeed.

Examination of Witnesses

Witnesses: **Edward Troup**, Second Permanent Secretary and Tax Assurance Commissioner, HM Revenue and Customs, and **Sarah Walker**, Deputy Director, Devolution, HM Revenue and Customs, gave evidence

Q176 Chair: Apologies to you, Sarah Walker. We are taking evidence from two people in this, not one. I am going to begin with a few questions to Mr Troup, who has the awkward task not just of thinking about this, but helping to work out how to do it administratively. I will come on to that in a moment. I just want to ask some very simple questions to get things straight. In principle, we were alluding to it near the end there with Dr Armstrong. Is it correct to say that it is just about always easier and more efficient to run a tax system as a single tax system in a unitary state and that any deviation from that is bound to cause some inefficiency?

Edward Troup: Taxes basically need to be effective in raising revenue. They need to minimise the burdens on taxpayers and businesses and hopefully minimise the costs to the tax administration. It is inevitable that in any single state with a single set of taxpayers doing that through a single administration and a single system is going to impose less cost—I would not comment on the economic efficiency—than having—

Chair: So the answer is yes to that?

Edward Troup: Yes.

Q177 Chair: Good. The second question is: although this takes you into the realm of what might be considered politics in the broadest sense, on the basis of your experience, which is a lifetime's experience looking at the tax system from the private and the public sector in various places, would you agree with the proposition that the most important single issue with respect to any tax system is that it secures consent?

Edward Troup: I do not think I need to go back to the private sector, but it is certainly true from any perspective, but certainly from the perspective of the tax administration, that the consent and trust of the taxpaying public is essential to achieve a level of compliance that you need to run a major developed economy.

Q178 Chair: Right, and therefore there is, in a sense, a trade-off between those two, what might be conceptually ideal for maximal tax efficiency and what is most likely to secure consent politically?

Edward Troup: A global tax system for the whole world would probably reduce costs and maximise efficiency—

Chair: You are taking it to extremes. I am only going as far as the UK.

Edward Troup: —but I do not think it would attract consent.

Chair: You are not challenging the proposition I have just made?

Edward Troup: No, I am not challenging the proposition. I was reinforcing the proposition.

Q179 Chair: We are past those first two. It has taken a bit longer than I thought it might, but anyway, we are there.

Is it preferable where taxes are being devolved—and you have mentioned the word “administrative” twice already—to retain a single administration system for collecting it, even where there is a high level of devolution? There are places in the world where this is occurring, for example, Quebec.

Edward Troup: The example of Canada is a good one, where having started off with separate national and provincial tax administrations, they have progressively moved towards having single tax administrations in each of the provinces, in some cases the national administration collecting national and provisional taxes, and in Quebec, having a provincial administration that collects both national and provincial taxes and divvies them up between the two taxing authorities.

Chair: Was that a yes to that one as well?

Edward Troup: Yes, it was.

Chair: I received three yeses in a row.

Edward Troup: You did.

Q180 Chair: That is what I wanted to hear, that your replies did not constitute qualification.

Looking at the range of proposals that have been on the table for devolution, and there has been quite a large number: income tax, of course stamp and landfill are already going through—or at least a measure of devolution on income tax; between 2015 and 2017 they are coming in as a result of the Scotland Act—and then there are proposals for more income tax, VAT, corporation tax, oil, PRT, other taxes as well, a raft of others. Looking at all of those, are all of those administratively, even if more inefficient to do, in the realm of possible and reasonable?

Edward Troup: I do not want to get drawn into the question of the merit and demerits of devolution of particular taxes, because that—

Chair: Other colleagues may have a try later on.

Edward Troup: I am sure they will. That is a political decision that will be taken in the fullness of time, but I think HMRC has shown that it can deliver administratively a range of quite complex measures beyond the core simplicity or basic elements of tax. If you have a think about the high income child benefit charge, which delivers an objective effectively, but

does so in a way that combines effectively elements of the benefit and tax system, we have effectively delivered that, as we have with a whole range of other initiatives. I can say I do not think there is anything in the proposals for devolution that we would not, if called upon to do so, be able to deliver, given of course appropriate levels of resource, because it—

Chair: I am sure there will be a spending bid.

Edward Troup: I am sure there would be.

Q181 **Chair:** But in a nutshell, HMRC can adapt to everything that is on the table, even at the radical end?

Edward Troup: Given sufficient resource and I would say time, because I think one of the lessons of the recent years is that given how important good IT systems and effective digital delivery are, these systems do, for better or worse, require time to get right, so there would be an element of time as well as resource.

Chair: Transition.

Edward Troup: Transition. Well, just implementation.

Q182 **Chair:** Transition and implementation are issues that need to be looked at, but in a nutshell, what you are saying is since HMRC could adapt to any of those that have been put forward, even at the radical end—and this maybe goes slightly beyond where you might want to comment—clearly that leaves space, if nothing has been ruled out on technicality or efficiency grounds, that must mean that the politicians need to sit down and do the hard grinding, not using various technical arguments, but just looking at what is most likely to deal with—the word that has been used today, “grievance”—the set of grievances that have arisen, which it has now held need to be assuaged.

Edward Troup: I would not want you to squeeze out the very practical issues of administration from the political debate, because taxes that themselves are administratively complex to deliver and impose burdens on taxpayers may themselves weaken the consent that goes with them, but I think—

Chair: But they are not the—

Edward Troup: Sorry, if your point from your opening question is that consent and political acceptability is the most important factor of a tax, then yes, I agree there needs to be political agreement and public acceptance overriding the questions of administrative convenience and administrative issues before they are squeezed out.

Chair: Or lobbying by those who pay these taxes.

Edward Troup: May I regard that as a comment rather than a question, please?

Q183 **Jesse Norman:** Can I ask you, Mr Troup, the Scotland Act 2012 sets out circumstances under which a taxpayer is to be considered a Scottish taxpayer and hence liable for the Scottish rate of income tax. There is a first question, which is it is true, isn't it, it has been suggested to by ACAW and others that this affects all companies in England, because even English and Welsh companies will have to fill in a form to say they do not have Scottish employees?

Edward Troup: I think you are opening up two levels of questions, and I would explain that Sarah Walker, who is responsible for the devolution team in HMRC and is responsible for the administration of the Scotland Act and specifically the Scottish rate of income tax, is here with me, so can help out on any technical issues. But I was not sure whether you were asking the question about the definition of Scottish taxpayer and whether we—

Q184 Jesse Norman: I am going to come on to that, but the point of information is first of all that it is going to apply to everyone.

Edward Troup: The point of information is that any company, any employer in the United Kingdom, might be employing a Scottish resident taxpayer from next year, and PAYE systems will need to adapt to reflect that.

Q185 Jesse Norman: Right, so this is not merely a Scottish problem, it is a problem—

Edward Troup: It is not merely a Scottish problem—

Jesse Norman: Good.

Edward Troup: —although the majority of companies and certainly smaller companies in England do not employ Scottish resident taxpayers and so in practice, although there may be a line of code or two—and as I say, Sarah can expand on that—in their PAYE software, in practice they will not have to do anything with it.

Q186 Jesse Norman: Good. Now we come on to the question of what is a Scottish taxpayer, and the first question is are you confident that you have identified all Scottish taxpayers?

Edward Troup: No, because we have not started the exercise of identifying them.

Jesse Norman: Sorry, are you confident you will be able to by the time the process—

Edward Troup: We are confident, yes.

Q187 Jesse Norman: Okay. You are not concerned about some of the worries that have been raised about the definition of what a taxpayer is within the criteria you have set out?

Edward Troup: The criterion, as you know, cascade from the definition of a UK taxpayer and then go to the question of whether you have a place of residence in the UK, and if you do, whether it is in England and Scotland. That will be determinative for the majority of UK residents, because they only have one home. For those who have two homes, then you ask a question about principal residence. Again, in the vast majority of cases, that is likely to be determinatively straightforward. There will be a small number of cases where the question of principal residence is unclear or changes during the year. There are mechanical tests about day counting that can be applied, and I do not think anybody has raised any technical difficulties with that. Obviously, we will have to deal with the administration of that, but we deal with the administration of residents and non-residents all the time because people come and go from the UK.

Q188 Jesse Norman: Presumably, there will be bump up in the number of reconciliations you will have to do?

Edward Troup: In terms of end of year reconciliations?

Jesse Norman: End of year, yes.

Edward Troup: I am not sure there will. Sarah, what do you think on that?

Sarah Walker: I think there may be cases where people have changed their residence during the year. If we are not notified immediately, then there may be discrepancies at the end of the year, so there will be some.

Q189 Jesse Norman: How many people move back and forth between Scotland and England every year?

Edward Troup: About 40,000 a year is the current estimate.

Q190 Jesse Norman: How many people have dual residencies that might be caught or that may want to dodge the system by changing their residence?

Edward Troup: There are two questions. We do not know yet. I do not think we have any estimates of those with dual residence. That will come out of the exercise that we are starting in October 2015 to start identifying Scottish residents. How many people will try to dodge? Nobody will try to dodge it until there is a differential in rate that makes it worth doing. If the Scottish rate moves to 11 pence or 9 pence from the initial 10 pence whether it would have a significant incentive remains to be seen, but I would have thought it was fairly unlikely.

Q191 Jesse Norman: Your estimates of compliance and non-compliance are going to be driven not just by technical factors, but by your estimates of the incentives because of differentials?

Edward Troup: The incentives in the tax system to not pay tax exist because tax operates at the levels it operates. If those are adjusted by 1 pence or 2 pence in one or two directions, I do not think the incentive is going to be between Scotland and England, it is going to be the incentive to pay tax or not pay tax that exists there. Our compliance effort will go into finding people who are trying to conceal their income, convert it into forms of income or otherwise have made—

Q192 Jesse Norman: You heard the testimony in the last session. Has HMRC done any preparation for what it would be for it to become a tax collection agency for a Scottish government as opposed to that being the addition to an English or British tax collection?

Edward Troup: In a way, we are becoming one, because the Scottish rate of income tax we will be collecting as part of income tax for Scotland, and accounting to the Scottish Government for the Scottish rate of income tax share.

Q193 Jesse Norman: Has any reflection been done on the constitutional or financial or other implications of that arrangement changing in any way?

Edward Troup: The financial implications, absolutely, and I have been up to the Scottish Parliament on a number of occasions to give evidence to them about the costs of doing that, so the financial side has been addressed.

On the accountability side, I am the additional accounting officer for Scotland within HMRC, and therefore, like any accounting officer, I am answerable to that Parliament—the Scottish Government—for the responsibilities to collect the Scottish rate of income tax that is

imposed on HMRC by the Scotland Act 2012. To that extent, those considerations have been taken into account already.

Q194 Jesse Norman: You will be charging the Scottish Government the full appropriate cost of what HMRC is doing, including a share of its central costs?

Edward Troup: Let Sarah remind us of how we are calculating our costs for recovery.

Sarah Walker: We are charging the Scottish Government the additional cost of operating a Scottish rate within the PAYE system, so all the additional programming cost, all the additional cost of contacting the taxpayers, we will charge. We will not charge a sort of slice of the entire cost of the income tax system for Scottish taxpayers, because we would have been doing that anyway, but all the additional cost—

Q195 Jesse Norman: You mean that will already be included in some way?

Edward Troup: We are already doing that, because for a given Scottish income taxpayer, if they are basic rate taxpayers, they will be paying basic rate income tax and National Insurance contributions at the moment and we will be doing compliance on them. After 16 April, they will still be paying 10 pence of English or for the rest of the UK income tax, and they will be paying 10 pence of Scottish income tax, and they will still be paying their NICs, so in a sense we have still have a majority interest in their compliance. As a matter of cost, this is only going to cost us an additional £4.2 million a year, so it is a very small amount of our overall running costs.

Q196 Jesse Norman: Understood. A final question: you do not perceive any possible conflicts of interest between your roles as accounting officer for Scotland in this regard and your overall role as accounting officer within HMRC?

Edward Troup: Lin Homer is the accounting officer for HMRC as a whole, but even if we combine the accounting officer roles, I do not think that there would be. We already as a department perform responsibilities beyond the collection of tax for the Treasury. We administer the national minimum wage, we collect student loans, we do a number of things for DWP and to all of those bodies we have responsibilities that we discharge, and we are now discharging responsibilities to the Scottish Government and we have an accounting officer arrangement.

Q197 Steve Baker: Good morning. You have explained that most people who are Scottish taxpayers will be simply resident in Scotland, I think I heard you say, but some people will have multiple homes or perhaps be working overseas or whatever and they will need to count the days.

Edward Troup: Yes.

Steve Baker: How many do you expect will have to do that?

Edward Troup: I do not know that we have an estimate of that yet. Sarah?

Sarah Walker: We do not have an estimate of the numbers, but it will only in practice occur to people who do not have a main place of residence in the UK, so they will probably be people who are temporarily resident in the UK. We would expect anybody who is a UK resident normally to be able to identify a main place of residence.

Q198 Steve Baker: So you have no estimate. I feel sure you must have some ballpark guess at whether you are talking about 10 people or 200,000.

Edward Troup: I think if you look at the totality of taxpayers—sorry, I am just quickly checking—there are something like 2 million Scottish taxpayers. I think I would say with some confidence that we would be looking at tens of thousands or a couple of tens of thousands at the most. As I say, I have not done the work and I do not want to be dismissive, because that is a significant number of people, but within the context of the 45 million taxpayers and filers we have, it is a small issue for us to manage.

Q199 Steve Baker: Thank you. I am grateful to you for being pressed on that point.

For those people who it would be tens of thousands—

Edward Troup: It could be. I am not saying it would be, but even if it were, that would be entirely manageable. It may be hundreds, it may be a few thousand.

Steve Baker: How would HMRC verify that their declaration of the number of days they had spent in Scotland was correct?

Edward Troup: Taxpayers make declarations to us in all sorts of circumstances in respect of their personal circumstances, in respect of the income, in respect of expenses. We do not, as you know, investigate every single claim that is made to us. We have moved progressively away from a system where we sought to check everybody to a risk-based system, where on a whole range of criteria—depending on the taxes, depending on the circumstances—we would identify those taxpayers and the characteristics of those returns that suggest particular patterns of risk, alongside some random enquiries, and on that basis we would investigate.

Q200 Steve Baker: Where does that leave you in terms of RIPA and surveillance powers? From what you have just said, it feels like where somebody might be considered at risk, you might extend the extent to which you use surveillance to verify where people are.

Edward Troup: The surveillance powers are, as you know, extremely proscribed in their application and we use them only in the most severe circumstances, almost always those cases involving criminality or suspected criminality. The idea that we would use those in routine compliance of factual declarations of income is extremely far-fetched. We just do not and would not.

Q201 Steve Baker: In saying that it is extremely far-fetched, are you ruling out an extension of surveillance under RIPA arising from these taxpayers?

Edward Troup: I think I would be, because although I am not completely familiar with the very limited circumstances in which we do use those powers because it is dealt with in a very tight part of the department, I can say with a very high degree of confidence that we would never use them in a normal compliance case where there was not some very serious anomaly and almost certainly a criminality suspected.

Q202 Steve Baker: Thank you. If Scotland acquired further powers over income taxation, do you expect that we would be looking at other ways to determine who was a Scottish taxpayer?

Edward Troup: I do not think so, because as I say, we have to determine who is a UK taxpayer anyway, and in a sense this is simply adding an additional territorial test. Yes, we would need appropriate compliance processes for that particular test and that particular liability, but it really is no different from whether somebody claims to be a Spanish resident or a UK resident or has dual residence and we have to determine which applies. There was nothing new here.

Q203 Steve Baker: We talked earlier about resources and HMRC's ability to deliver if provided with proper resources, but I notice from the briefing that you have invoiced the Government of Scotland £1,018,713, I think it is, in relation to this project. That feels to me an oddly accurate number for one thing—that is another story—but it feels to me like that would be at the low side of my estimate to how much money it would cost to implement this degree of complexity.

Edward Troup: I am sorry you find it odd that we are accurate. We quite pride ourselves on being accurate. Sarah, who is responsible for drawing these up, can tell you exactly what that covered.

Sarah Walker: Yes, that is the cost in 2013/14, so that was last year's cost. Because the income tax is not being introduced until 2016, we are still at a very early stage, so we are only doing the planning work. There will be substantial additional expenditure this year and next year. The estimate for the total cost of introducing the Scottish rate of income tax is between £35 million and £40 million.

Q204 Steve Baker: Over what period?

Sarah Walker: Between 2012/13 and probably about 2017/18 I think will be the last of the major spending.

Q205 Steve Baker: Thank you. The other issue on resources is what is HMRC doing to tell people living in the rest of the UK that they may be Scottish taxpayers, and those that may be Scottish taxpayers that they might have an obligation to count the days?

Sarah Walker: What we are planning to do is around about this time next year, so next autumn, we will identify from our own records and from any other databases we can use obviously people who we think are resident in Scotland and we will write to them directly, but we will also be doing general publicity in Scotland so that anybody who does not get a letter from us but is living in Scotland is encouraged to contact us and tell us their status.

Q206 Steve Baker: Thank you. I was not very clear: I meant the people in the rest of the UK who might end up, once they have counted the days, finding that they are a Scottish taxpayer. How will you ensure that people in the rest of the UK are aware that they might have an obligation to count the days?

Sarah Walker: The vast majority of those will not need to count days and they will not need to worry about that. If you live in England or Wales or Northern Ireland, it will not be an issue. The day counting may apply to people who come from abroad to spend a limited amount of time in the UK and then move between England and Scotland or other parts of the UK. In those cases, they will probably be getting advice anyway on their tax status and we would expect that to be coming through their advisers.

Q207 Steve Baker: If a person became a Scottish taxpayer through moving or acquiring a second home, or having a second home and spending more than half the year there and they became a Scottish taxpayer and it was a surprise to them because they had been previously clearly living in England for most of the year, how would you expect to treat such a person when what they pleaded ignorance, that they did not realise they had become a Scottish—

Edward Troup: I think you are raising wider questions of how do we comply generally, because you might acquire some small amount of income because you have a bank account that you did not previously have, and you are asking the compliance question, which is a very fair question, which is, “How do our rules apply when someone who has a source of income that they should declare and fails to declare?” In this case, that they are Scottish taxpayers and we subsequently find out about them. There is a whole penalty regime, there are interest provisions, so clearly if there was tax to pay, there would be interest if it was late paid. The penalty regime—and there is an awful lot on our website about this—shows that we take into account behaviour, co-operation and whatever it is and it is unlikely that unless there was a significant degree of culpable behaviour that there would be a significant penalty, but the law does provide for penalties in these circumstances.

Q208 John Thurso: Just on that last one, as the avowed policy of the current Scottish Government is to lower taxes, presumably your compliance problem will be to stop people claiming they are Scottish taxpayers when they are not.

Edward Troup: That would sort of logically follow, although as I say, there are lots of other incentives in the tax system and the differential would have to be quite significant.

Q209 John Thurso: It will be no different for somebody who, for example, is a resident of the Isle of Man or Jersey—

Edward Troup: Absolutely.

John Thurso: —so it is something you deal with all the time.

Edward Troup: Absolutely, yes.

Q210 John Thurso: Can I come, Mr Troup, to you first regarding HMRC’s business plan for 2014/16, which sees some quite significant changes and reductions in head count and fairly significant cost savings? To what extent has that business plan been cross-checked with the work that is envisaged with more devolved powers? Have they been able to make any estimate on that?

Edward Troup: It is always interesting doing business plans at this stage of a Parliament, because whatever happens under devolution, there will be a new government in the UK next year and history has shown that at the beginning of some parliaments, there is a degree of activity and HMRC gets asked to deliver a whole range of new things, so there is nothing new. Our business planning I will not say has a contingency for that, but there is an expectation within our business plan that we will have significant policy changes to deliver over the next few years, and Scotland is certainly registered on our list and devolution of those changes, but by definition neither the devolution proposals or what may happen in the next government can we specifically provide for, because we do not know what is going to happen, but we are prepared for a range of things. As I said in reply to the Chairman,

obviously things do require resourcing and if we are asked to do something significantly more, we will have a discussion with the Treasury about our funding.

Q211 John Thurso: It is fairly logical that setting up the administration that will be required for Scotland will have a cost, whatever that may be. If at the same time there is a reduction programme and redundancies and all of the rest of it going on, is it not a reasonable assumption that some of the people who are not required if we were not doing what we were doing for Scotland, their roles may be taken up by the activities that are required for Scotland?

Edward Troup: First of all, we have made significant reductions in the size of the department since it was formed in 2005 through the merger, we almost halved it, and at the same time we have increased our performance, we have doubled our compliance yield. So we have demonstrated that we can reduce the department size while improving its performance and we have done that largely by shedding what I might call sort of low-level manual activities through an increasing amount of digitalisation. Now, whether that means, if this continues, which it will, the jobs that we shared and the resources that we free up could be applied to particular tasks in Scotland, obviously there is a geographical question, because you might not want someone in the South of England and they might not want to go and work in Scotland if that was what was required, but there is also a skills issue as to whether the resources freed up would be the appropriate resources to do whatever is needed for Scotland.

Q212 John Thurso: Given the number of offices that have been closed—this is my opportunity to mention this again, but never mind—and the relatively poor performance of HMRC's telephone call centres, in a reasonable expectation of a rise in telephone enquiries, what steps should be taken to cope with that? Should it be a temporary thing or is there a need for a permanent increase?

Edward Troup: I think that is a very hypothetical question, but we do have a number of targets and one of them is call answering, as you know well, which we have worked hard to meet. It is hard work and we are doing it against the backdrop of reducing resources. We will have to continue to make the trade-offs as to where we put resources between compliance staff, transformation work to improve the digital service and help us reduce further and traditional call-handling and contact centre.

Q213 John Thurso: The sort of generally received view from most of our postbags and from the enquiries that we have undertaken and your own telephone surveys is you have a substandard call centre system. My worry is that if it is at that level now, if it is faced with a lot of enquiries relating to Scottish tax matters, it just kicks off with difficulties and whether or not you are planning—perhaps this is for Ms Walker—to have sufficient resource to deal with the initial one and then what extra resource will be required thereafter.

Edward Troup: I think there is a question for what we are doing at the moment and there is a hypothetical question about what we might do with a new set of devolution proposals. We do anticipate that once we start to identify Scottish taxpayers there will be some degree of additional call centre activity. I am not sure, and Sarah may or may not be able to tell me what we have done about this, and it is over a year away, of course, because we are not going to be doing any of this until the period before we implement the Scottish rate, but we will plan, as we do for any change, for any increase in call centre activity.

Sarah Walker: Yes, we have estimated that of the £35 million to £40 million for implementing the Scottish rate of income tax, £25 million of that is not IT change, it is not computer change, it is operational cost. The vast bulk of that will be dealing with enquiries around this mass mailing that we are doing this time next year to over 2.5 million people in Scotland, telling them that we think they are Scottish taxpayers and inevitably a proportion of those will call us, will reply to the letters. We will need to have the resources to be able to deal with that and we have factored that cost into the costs that are being met by the Scottish Government.

Q214 John Thurso: My fear that I am trying to ask you to talk about, and if I take a parallel that you will know about, which is the tax credits introduction, where they had the first debate in Westminster Hall on the subject of what was going wrong. The then Paymaster General told us there was absolutely nothing wrong with the computer and I was inventing it all and so on, and the rest, as they say, is history and the amount of money repaid and written off because of the computer problems, what are we doing to make sure there is enough resource so that these changes and the enquiries that come in are met properly and that we do not get into that kind of catch-up situation?

Sarah Walker: One thing we are doing, we are very conscious that the pressures on our contact centre are not constant through the year, we have particular peaks around the self-assessment deadline, for instance, and the tax credit renewal period, so we are deliberately scheduling this Scottish taxpayer mailshot at a time that is otherwise a trough, if you like, in our contact centre pressures. We do not have other big things going on at the time. We will have the capacity available, we expect, to be able to deal with and provide a good service to those enquiries.

Q215 John Thurso: Mr Troup, one last question for you, if I may, which is around the question of the possibility whether or not people will end up having to deal with two sets of tax authorities in the situation where say NI and saving taxation is not devolved, but other income tax is. Will people still have one point of contact with HMRC to resolve all the issues or will they be arguing with two separate sets of people to resolve whatever problems they may have?

Edward Troup: At the moment, the Scottish rate of income tax devolution proposals leave us, as you know, continuing to collect income and NICs from all Scottish taxpayers and then divvying it up behind the scenes with the Scottish Government. That leaves a single point of contact, because there is no Scottish income tax administration. Obviously if there were to be a devolution settlement that involved giving responsibilities, and remember, the Scottish Government are already taking on landfill tax, so if you are a Scottish business in the landfill activity—and there are very few of them, landfill operators—they will already have to deal with corporation tax with HMRC and landfill tax with Revenue Scotland as from next April. That is something that is happening anyway under the Scotland Act, but whether it happens under further devolution proposals is a political choice as to whether the administration of any part of the tax system, any more of the tax system, is given to the Scottish Government.

Q216 John Thurso: So a tax that is raised and varied in Scotland would be dealt with by Revenue Scotland?

Edward Troup: That is a political choice. You can have a tax that is—

Q217 John Thurso: Or one could say, “No, we will just have one. We will have the political choices can be made in Scotland, but the authority for collection and all of the rest of it can remain with HMRC”. There is a choice to be made.

Edward Troup: There is, and the experience in Canada, where they started off with separate but have ended up choosing to put them together is clearly an illustration of how this can play out.

Q218 John Thurso: For administrative purpose, as opposed to anything else, it would clearly be quite useful to keep this as simple as possible and have one authority or the other do it.

Chair: We have had a strong signal from you on that today, haven’t we?

Edward Troup: From the taxpayers’ perspective, that is certainly true.

Q219 Mr Ruffley: Mr Troup, good morning. What work has HMRC done to estimate the level of profit shifting and revenue loss should Northern Ireland get a lower corporation tax rate?

Edward Troup: I was not here to talk about Northern Ireland, and as you—

Mr Ruffley: No, but there is a link, as we will soon discover.

Edward Troup: No decision has been taken on Northern Ireland. The issues of how much profit-shifting might take place in the sense of just a parallel of issues that we have at the moment with the fact that our corporation tax is different from other corporation taxes around the world, I am not aware of any particular calculations of the estimate of any shifts of activities, but clearly it is something that might happen.

Q220 Mr Ruffley: Does that mean you have not done any calculations in HMRC?

Edward Troup: We would not within HMRC. This is a policy issue for Her Majesty’s Treasury, and in a sense I think you should ask them on the policy issue of what their analysis is.

Q221 Mr Ruffley: But one might expect there to be some profit-shifting and revenue loss and what do you think the impact on HMRC might be, the scale?

Edward Troup: I think that is rather similar to the questions on Scotland, that it is hypothetical until it happens.

Mr Ruffley: Of course.

Edward Troup: Our experience with dealing with corporation tax applying across jurisdictions is clearly extensive, because a very significant number of UK companies operate overseas and there are a whole variety of effects and behaviours of which a whole range of existing rules exist to manage and monitor. If the question is the administrative one, which is can we deal with it, yes, we can.

Q222 Mr Ruffley: Good, that is encouraging.

What is your view if there is further income tax devolution, whether 100% or less than that? Will that lead to a rise in individual self-assessment of tax liability?

Edward Troup: I am not quite sure. Again, this is a hypothetical question. Just looking back to the UK to what happens at the moment, we have several million of self-assessors who are also within the PAYE regime for a variety of circumstances, something like 5 million in the UK at the moment. That figure changes from year to year. I imagine if there is devolution, then it will continue to fluctuate.

Q223 Mr Ruffley: Again, more compliance work leading to administrative cost to HMRC, do you think that is likely to be manageable?

Edward Troup: I think it comes back to the opening questions. I do not think that there is anything here that we cannot manage.

Q224 Mr Ruffley: Thank you. Finally, Chairman, to what extent do you think employers' payroll management systems are equipped to potentially handle different rates and bands in relation to income tax?

Edward Troup: They do at the moment—

Mr Ruffley: Under the Scotland Act.

Edward Troup: —because while Scotland does change rates and bands and conceptually—

Mr Ruffley: But if there are further changes.

Edward Troup: Conceptually there is nothing different. Coming back to the opening point, that once you have identified your Scottish taxpayer, then the rates and the bands applicable to them will be operated within your PAYE payroll system.

Q225 Mr Ruffley: It would not be your expectation that there would be a significantly higher employer cost if there were further changes to allowances?

Edward Troup: All change involves cost, so clearly there will be costs, so in a sense, it is a quantification question and that itself is dependent on what the range of changes are.

Q226 Mr Ruffley: Of course, but worst-case scenario, with maximum change, you would not expect employers' systems, from what you have seen thus far, to be unable to cope?

Edward Troup: Payroll software is updated literally every year, not least because the tax system is changed every year as well as the systems get better, and I would envisage that any changes within income tax to bands and rates would simply—not necessarily simply, but would be accommodated with the payroll software for employers and allow them, once they had identified the Scottish taxpayers—which is the opening and most expensive part of this operation—allow those changes to be administered within payroll software and hence for the tax to be accounted for correctly.

Q227 Mr Ruffley: Thank you. Ms Walker, is that your view?

Sarah Walker: Yes.

Q228 Mr Ruffley: You have not heard anything from employers' organisations or there is no evidence you have seen that this would be unmanageable if there were to be complications or several challenges to allowances and rates?

Sarah Walker: No. Most employers should have had the ability to treat Scottish taxpayers differently since 1998, because the Scottish variable rate was introduced; obviously it was never used. We are building on that, so it is a familiar change. Once you have Scottish taxpayers separately identified by an indicator on their tax code then the employer can apply a different calculation. How complicated that calculation is, it is the separate identification that is the difficult thing in software. Applying a more complicated calculation within the payroll pay calculation is not significantly more difficult for employers. Different issues may arise if you change the base, so the income to which that calculation applies, but the calculation itself and the rates and bands should not be a big additional burden.

Mr Ruffley: Thank you.

Chair: Thank you very much for coming to give evidence this morning and thank you for being crisp and clear in all your replies. We are very grateful.