



Scottish Affairs Committee

Oral evidence: [The Smith Commission: Proposals for Further Devolution to Scotland](#), HC 835

Wednesday 14 January 2015

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Members present: Mr Ian Davidson (Chair); Mike Crockart; Mark Menzies; Graeme Morrice; Pamela Nash; Sir James Paice; Simon Reeve; Mr Alan Reid.

Questions 266-394

Witnesses: **David Phillips**, Senior Research Economist, Institute for Fiscal Studies, and **Professor John McLaren**, Honorary Professor of Public Policy, Adam Smith Business School, University of Glasgow, gave evidence.

Q266 Chair: Gentlemen, can I welcome you to this meeting of the Scottish Affairs Committee? As you may be aware, we have been conducting a series of hearings into various aspects of the Smith agreement, and we intend to continue doing that. That follows on from the investigations we had beforehand into various aspects of the referendum. There are two main areas that we want to cover with you: one is in relation to oil and subsequent changes in prices; the other is various aspects of the Smith Commission and the way it is proposing various financial settlements. Perhaps I could start by asking you to introduce yourselves so that we have on the record who you are and why you are here.

David Phillips: My name is David Phillips. I am a senior research economist at the IFS. I guess I have been taking the lead on work we did on Scottish independence before the referendum, and now we are looking at issues around tax and spending devolution, Smith and things like that.

Professor McLaren: I am John McLaren from Fiscal Affairs Scotland, which is a politically unaligned think-tank charity in Scotland. Prior to that, I was with the Centre for Public Policy for Regions based at Glasgow University, but we have now moved largely to being Fiscal Affairs Scotland.

Q267 Chair: Thanks very much. Perhaps we can start by asking you both to tell us what you believe to be the potential impact of the fall in the oil price on both the UK and Scottish economies.

Professor McLaren: In general terms and in world terms, the fall in the oil price seems beneficial. Both the IMF and the World Bank consider that it may be about 0.5% a year, but as the UK is both an oil importer and an oil exporter the impact on the UK's economy might be somewhat less than that. In Scotland, the impact on the economy will be larger negatively than the UK's in terms of employment and the possible knock-on impacts from that. Fiscally, even with the Smith Commission it will not be as large, because most of the revenues in the form of North sea taxes will still be coming through to the Treasury. If there was a method that accurately measured Scottish GDP, it would look pretty terrible, but as Scottish GDP excludes the North sea, even though technically if it was independent it would include it, it would look very different. That could have knock-on impacts if you were looking at it in those terms.

Whether a country—the UK or Scotland—will do better or worse depends on whether the fall in oil prices is due to demand or supply conditions. If it is an increase in supply, it is probably a good thing, because there is more on the market and that is what brings down the price; if it is a slackening off of demand, it is a bad thing, because it means the world economy is growing slower. Even though yesterday the World Bank said that the lower oil price would improve world growth, at the same time it said that world growth was going to be lower next year than it had previously anticipated, which it suggests is due to lower demand, which is a negative aspect for the world economy as a whole.

David Phillips: I agree with most of that. The OBR said recently that it believes that lower oil prices are a small net gain for the UK as a whole. It used to think it was broadly neutral, but as oil production has fallen in the UK, the downside from lower prices for oil has become smaller but we are still gaining just as much in the rest of the economy from the lower prices. For the UK as a whole, the OBR now thinks lower prices are a small net gain. For Scotland, however, because the oil sector is a bigger part of the economy there, you would not expect that to be the case; you would expect there to be more of a negative impact from Scotland's lower oil prices and lower oil production, particularly in the north-east of Scotland where most of that is concentrated. As John McLaren says, the impact on the public finances of Scotland under the current regime and under the Smith recommendations actually would not be that bad, because the North sea oil risks would be borne by the UK Government because it has not been devolved.

Professor McLaren: That is true, but because income tax is being devolved under Smith, and quite a lot of the workers in the North sea are well paid, it could have a negative impact on Scotland, but that depends when the baseline is. If a lot of people have their wages reduced, or are made unemployed, very soon, the baseline might be a couple of years down the line, in which case the adjustment to be made will already have taken that into account, which means that the baseline is quite important.

Q268 Chair: David, you said you agreed with most of what John said. I think we would encourage you to disagree, because we find that is more helpful to get nuances for any report we produce. I do not necessarily want to provoke you, but if there are disagreements it would be helpful to have them flushed out.

David Phillips: It is not really a disagreement but a slight difference in tone, I suggest. It is true that for the world economy as a whole, if it is a supply side shock that has reduced prices, that is a lot more beneficial than if it is a demand side shock. For Scotland specifically, there is still that role, but a supply side shock elsewhere—if production has gone up elsewhere and that has been pushing down prices: for instance, the shale oil and gas boom in America—can still have a negative impact on Scotland, even if it is the supply side, but it would be a somewhat lesser negative impact than a demand side one.

Q269 Simon Reeve: If you look at Scotland and England separately, I presume that because Scotland has a much smaller economy, of which North sea oil is a significant part, substantially it stands to lose because it does not have the economic capacity to take advantage of the reduction in cost caused by the oil price fall in the way England would. Whereas the English economy sees low fuel prices and there is an economic advantage to that—you were talking about half a point in terms of a global forecast—Scotland does not have a large enough economy for the benefits of the reduction in fuel to offset the problems caused by the reduction in income. That is if we were talking about two separate countries.

David Phillips: Indeed. About 80% to 90% of oil production occurs in Scottish waters, and you would expect a lot of the activity associated with that to be in Scotland, so potentially they have 80% to 90% of the direct economic effects there. On the other hand, only 8% or 9% of the overall economy is in Scotland, so they are getting 80% to 90% of the downside and only 8% to 9% of the upside risk. Those numbers are only approximations, because there is activity spread across the UK in the oil sector. In London there is oil trading, and companies provide services to the North Sea.

Q270 Simon Reeve: I know those were a sort of guesstimate, but could you tell me the numbers again because I did not quite catch them when you said them?

David Phillips: About 80% to 90% of North Sea production—the actual oil and gas extraction—takes place in Scottish waters. A lot of the activity to do that would be in Aberdeen, Edinburgh and the east coast of Scotland. For the economy as a whole and the non-oil sector, about 8% or 9% of that is in Scotland, so it is 80% to 90% of the downside and 8% to 9% of the upside, very approximately, because there are things going on in the rest of the UK to do with oil, like insurance in London, shipping and things like that.

Q271 Simon Reeve: But you are really saying that the downside is much, much bigger than the upside? Whatever the figures, whether it is 80% to 90% or 8% or 9%, the point you make is that there would be a lot of downside and not very much upside if Scotland was a separate country.

Professor McLaren: If it was a separate country or fiscally autonomous.

Simon Reeve: Yes.

Professor McLaren: What you are saying is largely correct, but it will not come out in the GDP figures that are currently published because they do not include the North sea or Scotland.

Q272 Simon Reeve: We cannot see that in the figures.

Professor McLaren: We do not have a like-for-like comparison; you have only got onshore Scotland versus the UK, which includes North sea oil. You can do the UK without North sea oil, which is different, but onshore, even pre-independence—if we can use that term—it would still have a larger impact. You only have to look at the housing market in Aberdeen to see that it is a rich place and there are a lot of wealthy people there. That can have a knock-on impact in terms of jobs and prospects, so there will be less of an impact than if it was independent, but there will still probably be more of a negative impact than in the UK as a whole.

Q273 Simon Reeve: You are right. It does not really matter whether it is fiscal autonomy or independence. If those things are separate, the consequences are as you describe.

Professor McLaren: Yes.

Q274 Chair: Can I ask whether or not you anticipate the oil price bouncing back up again in the short, medium or long term?

David Phillips: That is not something we look at at the IFS. We are micro-economists rather than crystal ball-gazers.

Chair: We thought it was worth a try.

Professor McLaren: Nobody saw this coming and nobody knows where it is going to go. That is in the short term and probably the medium term. It has always been a difficult industry and price to predict, but when you think of all the different things involved—what would have happened if nuclear power had not gone into abeyance after the problems in Japan; what is going to happen with the Arab spring or various other things in politics; what is going to happen in terms of global warming—all these things can very quickly have a big impact on the demand for and supply of oil.

However, putting that to one side, it is most likely that in the longer run there will be some bounce-back. What usually happens with large price swings like this is that people stop producing—the more expensive ones stop producing—so their capacity is brought down to the extent that eventually the price will edge its way back up. Even once it goes back up to a good price, if you are trying to get more oil into the market, it takes time—not as long now with shale in the US, but for the North sea it takes a few years to get new things going. I imagine there will be a bounce-back up in the longer term, but whether it will be over \$100, \$80 or \$150 is impossible to tell.

David Phillips: What I would take from the recent falls in oil price is not necessarily that oil prices will be lower than forecast a few years ago in the long term, or that the Scottish Government were obviously wrong in their forecasts, but two things. One is that the oil price is very volatile and oil revenues are subsequently very volatile. That adds additional risk to a system of full fiscal autonomy or independence for Scotland. Secondly, when making oil forecasts it is important to look at downside as well as upside risks, which was not always the case in previous debates. Whereas in the past maybe the downside risks

were not being taken account of, now it is important that we should not think there is no upside as well. Prices may rebound and they could go higher than before. It is very difficult to predict oil prices. The key thing about oil revenues is that they are very volatile.

Q275 Mr Reid: You said earlier that under Smith, with income tax being devolved, a fall in the oil price would lead to lower income tax revenues. Under Smith, is that the only impact that a fall in the oil price would have on the Scottish Government's finances, or are there any other impacts?

David Phillips: It could impact on VAT revenues. For instance, if people have lower incomes and therefore spend less in the shops, that could impact on the 10 percentage points of VAT that are being assigned. It could have impacts on claims for disability. What we saw previously with the decline in manufacturing was that many of the older workers who lost their jobs claimed disability benefits. If there was a long-term decline in the North sea oil sector, with the devolution of disability benefits to Scotland there could be some impact. Because of the concentration of high earners in Aberdeen and other areas in the oil sector, income tax is probably the main immediate impact. As John said, whether that is a bad or a good thing for Scotland depends on where the baseline is set for taking income tax off the block grant. If all the falls in employment and earnings take place before that adjustment is made, Scotland doesn't lose out. Actually, it could gain; if it bounces back again, it gets that upside. If the adjustment is made before these falls take place, Scotland could lose income tax revenues, so the effects on Scotland's budget depend on when the adjustments are made to the block grant.

Professor McLaren: Because these people are well paid they tend to pay higher earnings tax. Higher rate taxpayers pay disproportionately a very large percentage of overall tax-take, so potentially it could be quite significant.

Q276 Mr Reid: There are all these impacts on income tax and VAT. Are you able to quantify how much that impact would be compared with, say, full fiscal autonomy? I am trying to get a feel for Smith versus full fiscal autonomy, if we assume that the oil price stays at its present level.

Professor McLaren: Fiscal Affairs Scotland does a monthly bulletin publication. We brought up this particular aspect and said it was something that both the UK and Scottish Governments needed to look at, because it could potentially be quite serious. North sea oil revenues are expected to be only about £3 billion this year anyway and they might come down to £1 billion or £2 billion. As a lot of the high earners pay a large amount of income tax—about £10 billion—I am not saying it would be a bigger impact but there could be a significant impact. I do not think anybody has done any work on it; we just have estimates of how many people are involved in the North sea industry. Obviously, it is not just oil workers; it is onshore workers and related trades as well, and a lot of them live in England. For those who live in England and Scotland, it is supposed to be about 50-50, but there would be a disproportionately bigger impact on Scotland.

Q277 Mr Reid: If they lost their jobs in the oil industry, are these well-paid workers likely to stay in north-east Scotland, or if they have a marketable skill will they go elsewhere in the world?

Professor McLaren: A lot of them live elsewhere anyway, but whether the ones who currently live in Scotland would decide to up sticks and go to North Africa, the Mexican Gulf or whatever depends on what the market is like. I guess the market is pretty poor all round in the oil sector at the minute, but I am not aware of much research in this area.

David Phillips: Nor am I. A couple of steps are needed. First, you need to estimate the impact on employment, earnings and income, and then try to work through the implication for taxes. It is a very complicated exercise. It's not one we are doing at the moment and it's one where there could be lots of assumptions and disagreements between the Scottish and UK Governments, so it is a very tricky question to answer.

Q278 Chair: You said that the assessment of income tax and so on will depend very much on the baseline. I think I understand that. What is the norm in these sorts of circumstances? Do you take a five-year rolling average, or is there a single point at which an estimate is made and you work forward from there?

David Phillips: I can describe the way it is going to work under the Scotland Act provisions. Under that Act, 10 pence of each tax band has been devolved to Scotland. In year one—the first year it is being devolved—they are taking from the block grant what they expect those 10% bands to raise in Scotland in that year. Year one is nice and easy. The question is what you do in years ahead. What they are supposed to do under the Scotland Act is say, “We’ve taken £4 billion off in the first year.” That is what it is approximately. “We’ll change that next year in line with what happens from the same tax base in England, Wales and Northern Ireland.” If that tax base goes up by 10% because of growth in the economy, that £4 billion will be taken off the Scottish Government to account for the revenues they are getting from income tax, and they will increase that by 10%. In the next year they will take off £4.4 billion, which means that if Scottish Government revenues go up by less than 10%, they lose out from devolution; if they go up by more than 10% they gain from devolution. The idea is that you are providing an incentive to the Scottish Government to grow their revenues, because they lose or gain depending on whether they go faster or slower than the rest of the UK. That is the way it has been done before. You make an adjustment based on one year and then index it relative to what happens to tax revenues in the rest of the UK. That is the precedent that has been set, and that is one of the things being discussed now for devolution under the Smith Commission proposals. It becomes more difficult if the year you start is an unusual year. If it is a year of very poor tax revenues in Scotland because all the workers are laid off in the oil sector, and in the next year oil revenues go up quickly in Scotland because they all go back in, Scotland could end up gaining because of the start year, or it could end up losing because of the start year.

Q279 Chair: I was asking whether or not it is a snapshot or some sort of average over a period. An average over a period could be seen to be fairer for both sides on the basis that it is more representative, whereas a snapshot, depending on the time it is taken, could be unfair to one or the other.

Professor McLaren: I think it will be looked at as part of the negotiations, and if one side or the other thinks, “Hang on a sec. That doesn’t look good from our point of view,” part of the negotiations will be, “Let’s make it an average over a three or five-year period,” or something like that. If it looks as if it has been the same trend for five or 10 years, you can take a snapshot, but if there is an obvious kink people would probably start to say we need a moving average of some kind. I do not know how they do it in other countries.

Q280 Chair: We have an obvious kink at the moment, don’t we?

Professor McLaren: It looks like we will; I do not know whether we have it yet. I am not sure how many people have been laid off, or how many wage reductions have happened yet in North sea-related industries, but it looks like it will happen over the next couple of years.

David Phillips: You have to look at it almost on a case-by-case basis. There could be circumstances when taking a five-year moving average would be inappropriate. For instance, if there was a long-term trend where the proportion of tax revenues in Scotland was rising or falling, by taking a five-year average you would end up not taking into account the fact that recently, or in the last year, a bigger proportion had come from Scotland. There is no nice one-size-fits-all solution; there are lots of tricky issues in the implementation of the Smith Commission proposals. The biggest ones are what you do with the block grant. This is the real unanswered question at the moment.

Q281 Chair: There is enormous potential for grievance, isn’t there, from one side or the other about how the figures are calculated?

Professor McLaren: There is certainly potential for dispute. I guess this happens in other countries and there must be ways of getting round it, but I do not know whether that is due to the politics of countries that have become used to it, so they do not become aggrieved about it, or whether there is a big dispute in these areas. I do not have enough understanding of Germany, Canada, Australia or whatever to appreciate that, but if you wanted to make mischief, it would be possible to do so, because you would be saying, “Look at the figures; we’re losing out here.” Either side could be saying that, depending on the starting point.

Q282 Mr Reid: Under the Scotland Act 2012, can you tell us what years were included for the baseline?

David Phillips: It is different for different taxes. They are devolving stamp duty and landfill tax this year, and they are devolving income tax from next year. I’ll be honest: I am not entirely sure whether they take the baseline from the year before devolution based on what they estimated revenues to be in the year before devolution, or what they estimate they will be in the first year of devolution.

Q283 Mr Reid: I don’t think it will be different for stamp duty, because the English rules are being changed at the same time—or changed halfway through the year.

David Phillips: Yes. I know that in that specific example they are making an adjustment to account for the fact that the regime has now changed in that particular case.

Professor McLaren: The adjustment for stamp duty and landfill has not been agreed.

David Phillips: It has not been agreed yet. That is still ongoing.

Professor McLaren: Which suggests there is enormous potential for disagreement.

Chair: There is precedent there for a potential row, isn't there?

Q284 Pamela Nash: I want to explore further the dependence of Scotland on oil revenues. In your view, how dependent do you think a fiscally autonomous Scotland, or a separate Scotland, would be on oil revenues?

David Phillips: Clearly, it would be more dependent on oil revenues than the UK as a whole is. The decline in oil revenues we have seen so far means that there are less of them, so in some respects it is less dependent on them because there is less revenue for it to subsequently lose. I am not sure that was the most revealing answer, so let me put it another way. A few years ago, oil revenues were forecast to be £5 billion, £6 billion or £7 billion a year for the UK as a whole. Scotland would be getting about 80% to 90% of those, or £4 billion, £5 billion or £6 billion a year. That would be about 10% of its overall tax-take. For the UK as a whole, it is about 0.8% of the tax-take, so it is a lot more significant.

Q285 Pamela Nash: Is that 10% an agreed figure? The figure I have is that it is about 15%.

David Phillips: It depends on the year you take and the baseline. Maybe that figure comes from 2012-13.

Pamela Nash: Yes, I think it does.

David Phillips: Now that oil revenues have fallen, it is slightly lower. In the past it has been between 10% and 20%. As those revenues fall, that would clearly knock a bigger hole in the budget of a fiscally autonomous Scotland or an independent Scotland. I ran some calculations when we were doing some work before the referendum. They suggested that, if you look at public spending and onshore taxes, the budget deficit or the budget balance of a fiscally autonomous or independent Scotland would be about £8 billion more in the red than the equivalent for the UK as a whole. That means that if Scotland has more than £8 billion in oil revenues it has a stronger fiscal position than the UK as a whole; if it has less than £8 billion it is in a weaker position. With oil revenues now coming down towards maybe £1 billion, £2 billion or £3 billion, that would clearly knock a sizeable hole in the budget of a fiscally autonomous or an independent Scotland. That does not mean there can't be ways of dealing with these things; spending could be cut, or if policies could be found to grow the economy onshore to make up those revenues, that could square the circle. But clearly in the short to medium term, a fall in oil revenues would be a much more significant negative for the public finances of a fiscally autonomous or an independent Scotland than it would be for one that gets a lot of its funding from a block grant and from the UK as a whole.

Professor McLaren: Work we have done also shows that, if you ignore the North sea, Scotland benefits from being part of the UK at the minute by about £7 billion to £8 billion in terms of transfer. As David says, that is what North sea revenues would have to be. In 2011-12 it was £11 billion, so it was well above; this year it is expected to be £3 billion, which clearly is well below. Even at the time of much of the debate around the referendum, I think the Scottish Government's top scenario for North sea revenues, scenario six, was about £8 billion. Even at the top scenario, it was only just breaking even. We have not had any updates from them, but anything below—we are now possibly looking at below £1 billion if it stays at around \$50 to \$60—is a gap that would have to be filled in some way. Even at the time of the referendum there was a probable gap to some degree; now it has got larger and worse. Then again, if oil goes back up—if something happens, it could go back up; in 2011-12 it was £11 billion, and that is not very long ago. These things are highly erratic. You cannot trend them forwards.

Certainly, the position at the minute does not look good, but that would suggest, as a number of economists, including the Council of Economic Advisers, have said, that what you should do with oil is not include it in your public finances but save it in an oil fund. That does not mean to say that it is a bonus that you can just squirrel away and everything is hunky-dory; it means that you should build it up to allow for high and low prices and high and low revenues in the future. If you are going to do that, you have to address the problem it leaves, which is the £7 billion to £8 billion mismatch between revenues and expenditure. You have to find some way for your non-oil balance to be matched, which would be a big ask. That is theoretically, I think, the position of people like Stiglitz and others.

Q286 Pamela Nash: You are saying it is a big ask to do that. It would leave a big hole in Scotland's public finances.

Professor McLaren: To do that would mean cutting services, increasing taxes or increasing borrowing.

Q287 Pamela Nash: Do you think that if Scotland was fiscally autonomous it would be able to withstand that reduction in the funds available to it?

Professor McLaren: There are some areas where it is quite clear that they would make savings—in defence, for example. That could be billions, potentially, although it would also have knock-on impacts on the jobs of people involved in defence. Nevertheless, if you are looking at that size, it is a very difficult transition period.

Q288 Pamela Nash: I can understand the argument if Scotland was separate—if it was independent—but if there was fiscal autonomy within the UK they would not have that reduction.

Professor McLaren: No. If it was fiscally autonomous, it would take that away. Also, the debate that was going on during the referendum around debt interest payments? I don't imagine that would be up for debate anymore, because the pound would still be used by everybody, so Scotland would be paying its debt interest share. You could not take that away, so it goes back to more fundamental things.

David Phillips: To put it in context, £8 billion is about 14% of overall public spending in Scotland. It is about 18% of tax revenues in Scotland, so it is a sizeable amount. Scotland has substantially higher public spending per person than the rest of the UK. There is an argument about how much that is to do with need and how much is excess funding. That is not something to get into here, but if cuts were made to public service spending, for instance, it would mean going down to a level of spending about the same as the UK average, as opposed to being at the moment about 25% higher than the UK average for devolved public services.

Q289 Chair: You were saying that if oil was 14% of public spending, and the oil money was put into a fund to allow for fluctuations later on, effectively that means the 14% would either have to be cut from public spending, or it would be a combination of cuts, income tax rises, borrowing and growth.

David Phillips: I was not saying that oil revenues make up 14% of public spending; I was saying that £8 billion—that gap between spending and taxes, if you ignore oil—is about 14% of public spending. If you closed up all that gap so that Scotland had the same fiscal position as the UK as a whole, you would need to find the equivalent of 14% of public spending, or 18% of tax revenues, to fill that entire hole. You might think you do not need to fill the entire hole because Scotland could borrow a bit more than the rest of the UK. Full fiscal autonomy would potentially give it the power to do so, but if it wanted to balance its budget on the basis of onshore revenues only, it would be looking at very big changes. Even if it wanted to balance it on the basis of including the oil revenues, if those oil revenues remained at low levels, there would still be very big changes, although, as John said, if they do rebound, that could make the fiscal position look a lot better under autonomy or independence than it currently does.

Professor McLaren: If you put the oil revenues in a fund, that fund will build up and over time you will be getting interest from it, which will start to feed into the normal budget. That is what Norway does, but it has built that up with huge excess resources.

Q290 Chair: To be fair, over time we are all dead. I am thinking much more immediately.

Professor McLaren: That is why I see it is a transitional period in particular.

Q291 Chair: That's right, so there would require to be a combination of the four things you have already outlined: cuts, tax increases, borrowing—presumably, the amount you can borrow on an ongoing basis will be limited, since Scotland as a new borrower will not have an established record—and growth, which presumably would take a certain amount of time to build up.

David Phillips: Indeed.

Q292 Chair: In the short term, the situation would be extremely difficult, would it not?

David Phillips: If you move to full fiscal autonomy, in the short term, with current levels of oil revenues or the desire to save those oil revenues, it would require very substantial

changes to other taxes or public spending. You can do a bit on the borrowing side, but you are right—you would not want to do too much. Of course, growth can help in the long term, but having higher taxes or lower spending could stymie growth somewhat—if you are taxing people more and not investing in infrastructure. There would be real challenges in implementing full fiscal autonomy in the short term, medium term and maybe even the long term, depending on the growth path and how quickly you build up investment returns from any oil fund you have.

Professor McLaren: Because there was so much dispute around figures over the referendum period and beyond, there is actually a lot of agreement about the underlying primary balance difference between Scotland and the UK—that £7 billion to £8 billion. The disagreement comes from what future oil will be because it is so uncertain, and the new twist in the tail recently is what debt interest payments might be if Scotland was independent rather than fiscally autonomous. For the rest of it, by and large, the figures are agreed by the UK Government, Scottish Government, ourselves and the IFS.

Q293 Simon Reeve: I thought you said that if the value of oil revenue was £8 billion it was equivalent to 14% of public services, but when you were asked about that you said no, but then you talked about equating 14% with £8 billion. I do not understand.

David Phillips: I interpreted the question as: are oil revenues at their current level 14% of public service spending? They are not. If they were £8 billion, they would be.

Q294 Simon Reeve: Yes. An oil revenue of £8 billion equates to 14% of public services. If you took revenue out of the equation, and the revenue was the £8 billion figure, there would be a 14% reduction in public services to match that.

Chair: Unfortunately, *Hansard* does not record nodding. Therefore, you have to say something.

David Phillips: Yes.

Q295 Mr Reid: I want to make sure I have the right figures. You said the Scottish Government's projection before the referendum was £8 billion income from oil.

Professor McLaren: Up to £8 billion.

Q296 Mr Reid: At the moment, given the current levels of oil price, you are saying it should be about £1 billion.

Professor McLaren: No. In the autumn statement they were saying it would be about £3 billion, but that was on an assumed price of \$85 a barrel.

Q297 Mr Reid: At the present level of \$50—

Professor McLaren: It could well be. There are a couple of estimates, one made by the OBR in the longer term and one made by a group called N56, both of which suggested that it was going to be around £1 billion, or possibly less than that, at that \$50 price.

Q298 Mr Reid: That is a £7 billion difference. You said that on the basis of £8 billion, to fill that gap taxes would have to go up by 18%, so for £7 billion it would be about 15% or 16%. Is that correct?

David Phillips: Approximately. I can get the exact figures for you afterwards; I have access to all the numbers, if you are interested.

Q299 Mr Reid: Yes. That would be helpful. If our mental arithmetic is correct and it is 15% or 16%, under full fiscal autonomy, to make that up through taxes, presumably it means that across the board every tax in Scotland would need to go up by 15%. Is that right?

David Phillips: You would have a choice about which way to do it. You could do a mix of tax and spending changes. You could choose to increase some taxes and not others, but if you did it across the board on all taxes the average amount of revenue you would need to get from each one would be 15%. I should point out that that is not the same as 15 percentage points. It is not like income tax going from 20p to 35p on the basic rate; it is the revenue that is going up by 15%.

Q300 Mr Reid: For example, if it was decided to recoup all this money through income tax, are you able to tell us what the level would need to be?

David Phillips: Not off the top of my head, but it is worth noting that income tax revenues in Scotland are about £11 billion a year. If you want to increase that by £7 billion, that is an increase of 60% to 65% in income tax revenues.

Q301 Mr Reid: If you made it the same across all rates, 60% to 70% of 20 pence is about 14 pence in the pound, so a 14 pence in the pound increase in income tax would fill the gap.

David Phillips: If you ignore any behavioural responses.

Q302 Mr Reid: That is the problem.

David Phillips: They would go in the other direction.

Q303 Mr Reid: The problem is that if you put up tax there is a disincentive to work and you get less in. Equally, if you cut expenditure that inevitably means people losing their jobs and therefore less tax income comes in. If you were the Finance Minister of a devolved Scotland with full fiscal autonomy and income from oil of about £1 billion, what would you do—I wish *Hansard* could record that look of angst.

David Phillips: It would be a choice for the Government of a Scotland in that situation to face. There are options on the spending side and options on the tax side. The UK is aiming

to run a fairly substantial budget surplus in 2020. The Scottish Government decided they do not want to run that kind of surplus but to have a balanced budget so they can do a bit less on the fiscal tightening side than the UK Government. There is a range of options to consider, but that is not to say those options would not involve very tough decisions for public services, or taxation or further borrowing.

Q304 Mr Reid: There does not seem to be a solution. If you put up income tax to 14 pence in the pound you do not get all the extra money in, because there is an impact on behaviour and fewer hours are worked. Equally, if you cut public expenditure people are out of a job and less tax comes in. How do you solve the problem?

David Phillips: Clearly, there would be knock-on effects from an increase in taxes or from cutting spending. It would be up to the Government to decide which ones they are willing to bear. Public spending is considerably higher per person in Scotland. The figures I have run suggested that on the devolved services spending is about 25% higher than in the rest of the UK. They might look to make savings there, or they could look to increase taxes if they wanted to maintain public services. Those are very tough decisions, and I am glad I am not the one who will have to make them.

Q305 Simon Reeve: If it was a 14% reduction, it could come from reducing expenditure to the UK average at present.

David Phillips: I can probably run the numbers more exactly when I am in front of my computer, but approximately you could fill that entire gap by reducing it to the UK average level. But Scotland might have higher needs for public spending in certain areas because of its slightly older population, its levels of deprivation and its geographical dispersion. You might not want to do it all on public services. Interestingly, it is not on the big services that Scotland spends extra money. Our research suggests that it is spent on the smaller services like enterprise and development, transport, housing, community facilities and culture; it is not the NHS and schools. They would have to look at smaller services if they were looking to make cuts to meet the average level. For bigger services, spending is not that much higher than the UK average at the moment.

Q306 Mr Reid: What about university tuition fees?

David Phillips: That is one area of policy difference, but spending on education per person is only about 4% or 5% higher in Scotland than in the UK. It is more on universities and somewhat less on schools per person, although that partly reflects the fact that there are fewer children in Scotland.

Professor McLaren: If the position you are talking about was part of fiscal autonomy, I imagine they would say, “We should go for independence.” That would allow you to save on defence and negotiate on debt interest, overseas properties and stuff like that to try to get a better deal. That would be relatively costless.

Q307 Mr Reid: If you cut defence, you would have fewer people working.

Professor McLaren: I said “relatively costless”. Those are areas where you could do something that would not affect basic services—education, health and so on. Whether it would get you the whole way is a different matter. If you are talking about £1 billion, that is probably not going to be a long-term figure. Whether it is £3 billion or £5 billion, it still leaves a gap which could be a difficult gap, but it is easier to deal with.

Q308 Mr Reid: But even if it is £1 billion for one year and the gap could perhaps be spread over several years, it is still a significant gap.

Professor McLaren: If the referendum had gone the other way and it was full steam ahead, it looks like it would have been a difficult starting point.

Q309 Mike Crockett: I want to ask about the starting point. One of the options to deal with the volatility of the oil price is to borrow to fill that gap. Even if it is just a one-year gap, you stabilise it by borrowing. Scottish Government forecasts were that a variation of £1 billion in tax revenues would change the fiscal position by about 0.6% of GDP. Given that we are talking about a variation on Scottish Government forecasts of potentially £6 billion, that suggests that quite a significant amount of borrowing would have to be done, perhaps as much as 6% of national income. Is that doable for a potentially independent and newly set-up Scotland?

Professor McLaren: The whole issue of what Scotland would be able to borrow at if it was independent or fiscally autonomous was discussed a lot around the referendum. It is a difficult one, because there is no track record, so when it came about, the markets would ultimately decide. Most commentators seemed to suggest that Scotland would have to pay more to borrow, but it is difficult to know exactly how much more.

As a technical issue, it depends what you mean by GDP. If GDP includes the North sea and it is in real terms or in current price terms, those figures move a lot depending on whether the price is going up and down or production is going up and down, both of which have happened significantly in recent years. It may not be as much, or it may be quite a lot, depending on which way you look at it, and that would depend on which way the markets looked at it. If you look at Scotland as an independent country, its GDP is inflated by the North sea, because that is quite a large amount of money, but most of it does not come to Scotland; it goes overseas because it is overseas owned, so Scotland’s underlying GNP, which is a more appropriate measure, is considerably lower. Therefore, the markets should take that into account, which would magnify the impact you are talking about—they should take that into account. The bottom line is that probably there would be a degree of higher debt payments relative to the UK’s, but how much is pretty difficult to estimate at this time.

David Phillips: It would partly depend on how successful Scotland had been in negotiating its initial debt allocation. If Scotland had been allocated a population share of debt valued at 70% to 75% of GDP—I am using GDP figures because those are the ones I know—that is quite a high level for any country. A 6% deficit there would look worse than if Scotland had a very successful negotiation and managed to say, “We’re going to walk away from the Union with no debt, or a smaller share of debt.” It is quite hard to say how markets would react because it depends on a large number of variables: how much debt Scotland inherited and what the trends were in Scotland. If in the first year Scotland was borrowing

6% but it had a credible medium-term plan to get its deficit under control, it would look very different from a situation where it had no plans to get its deficit under control. It is a bit like the argument the UK Government have made about needing a credible plan for the UK deficit. It would be more difficult for a small country with no track record of borrowing, and a very thin bond market as a result, to borrow that level of GDP than it would be for a larger country like the UK. In the recent past, the UK has been borrowing 8%, 9% and 10% of GDP in the year. You can borrow those amounts of money if you have a credible plan to reduce borrowing, but of course that would mean either hoping that oil revenues will go back up, or tax increases or spending cuts.

Professor McLaren: It is what you are doing, not necessarily where you are. Ireland has a lower borrowing rate than the UK at the moment, even though it is still not in great shape. Greece is in trouble, but the rates in Portugal and countries like that are pretty low, as they are in most developed countries of the world, so seeming credible is an important part of determining what that borrowing will be.

Q310 Mike Crockart: The situation in those countries is pretty bad, but they have a credible plan for bringing that deficit down.

Professor McLaren: Yes. For example, people see Ireland going in the right direction having done very strong things to get things under control.

Q311 Mike Crockart: The other thing the Scottish Government talked about a lot was creating a stabilisation fund to cope with these kinds of shocks of volatility in prices. That takes a while to build up, but what level of stabilisation fund would have been necessary to cope with a shock of the size we have seen in the last year?

Professor McLaren: The Scottish Government proposed two funds: one was a stabilisation fund and the other was like a savings fund. The stabilisation fund was to take all those things, as you suggest; the other was to save all the excess. Clearly, the way it is going at the minute you would need a rather large stabilisation fund, but you have to build up both those funds over time. If revenues are considerably lower than expenditure, you do not have the ability to do that because you are borrowing. You have to get into a position to create the stabilisation fund in the first place, and it looks like this stabilisation fund would have to have been pretty big. Norway does not have a problem because it has an enormous fund, and they can dip in and out of it, but I would have thought the prospects of that happening now in Scotland are close to nil.

Q312 Mike Crockart: When you say “pretty big”, what does that mean?

Professor McLaren: Say Scotland had been independent since 1999, and in 2011-12 it was getting £11 billion in. It has been going down ever since; in 2015-16 it might only get £1 billion in. If you put your average at £8 billion, maybe you are saving up for a couple of years, but then you are looking at £7 billion a year. Because the markets are so uncertain, you could be looking at four, five or six years of very low revenues, which could mean that a £20 billion or £30 billion fund would be wiped out in that time. Because nobody can plan what will happen to North sea oil, these funds ebb and flow as they do. Norway’s has continually grown, because it has so much oil relative to its population that

it can do it, although, interestingly, Norway did not start its oil fund until 1996, so for almost 20 years they were just spending all the money coming in on things. If you look at other countries, they are building up stabilisation funds. They might have a plan in their head, but they react to events at the time. There is no standard practice for deciding what is a safe fund.

Q313 Mike Crockart: But with the benefit of hindsight, given the potential of four or five years of a £5 billion to £6 billion shortfall, you would have to have a stabilisation fund upwards of £30 billion or £40 billion.

Professor McLaren: To go back to a point we made earlier, ideally you would not have much of a stabilisation fund because you would assume that you were going to try to balance your onshore spending with your onshore taxation so that all the money went into your savings account. That is roughly what Norway does. You would not need that first stabilisation fund because it would be all for future generations. You would then say, “We want to spend some of it now and save some of it.” You would make a conservative estimate: “We expect to get at least £3 billion a year and we will spend that now; the rest we will save.” That would mean your stabilisation fund does not need to be that big because you are only going to move from £3 billion down to £1 billion. It depends on which way the Government decide to set up and use their oil funds in terms of being cautious economically.

David Phillips: I would agree with all of that. Although we are talking about stabilisation and the savings funds that the Scottish Government have mentioned, the rules that might apply to them about saving anything above £3 billion, or saving all the revenues in those funds, are quite different from the rules the Scottish Government have been suggesting. They talked about maintaining the current fiscal stance and diverting—effectively borrowing to save. The fiscal plans they set out included, even in 2019 when they have higher oil revenue forecasts, some level of Government borrowing, some of which would go towards the stability fund. Rather than saving the money, they would be borrowing some money and labelling it as stored away for a rainy day. The kinds of funds we are talking about here are quite different from what was being discussed in the run-up to the referendum.

Q314 Mike Crockart: Because the plans were to spend all of the oil revenues—

David Phillips: Because the plan was to spend the oil revenues and borrow a bit on top of that, and then use some of that borrowed money to set up a stabilisation fund and a savings fund.

Q315 Chair: Borrowing to save was basically the way it was working.

David Phillips: Yes.

Q316 Chair: Presumably whether or not that was worth while would depend on whether or not the interest you were paying on the money you were borrowing was greater or less than the receipts, or the gains you were making from investments in the fund.

David Phillips: Precisely, yes. The Scottish Government would argue that oil revenues will increase further in the medium term as all the investment in the North sea pays off; that the economy would grow and tax revenues would grow; and in the years ahead that would fill up the budget. Some of the oil revenues could then be saved, but in the short term at least the plan was to borrow the money that would be saved in these funds.

Professor McLaren: The Scottish Government pointed out that the Norwegian Government got a higher return on their assets than they would have had on borrowing. However, I think they chose years that made it look particularly good. If you took a wider range of years, it would look different.

Q317 Chair: That was my understanding. You mentioned being able to borrow against a credible plan. Would it be considered credible to plan for the oil price to rise, in the sense that you are going to refund that borrowing by assuming the oil price would rise in due course? Would that be seen as credible?

David Phillips: There are two points. First, the initial forecast they made for even 2016-17 to 2018-19 was £7 billion a year, around twice as high as the OBR's forecasts for those years. They made the valid point that the OBR had been wrong in the past and revenues could turn out to be higher, but, as we have found out, they can also turn out to be lower than the OBR's forecasts. There may have been a question about whether or not the initial forecasts were credible.

Looking further ahead, whether or not the plan for further price and production increases and economic growth to square the circle would be seen as credible will depend on the circumstances in the North sea at the time—if it looked like production was coming on stream—and whether the markets believed that the policies of the Scottish Government to improve the economy, boost growth and so on could feasibly deliver that. It is possible they could, but it is much easier to say that than to deliver that extra growth. It is not impossible that that would be seen as a credible plan, if they had policies that made it appear credible, but the challenge was to create those policies. We did not really have those policies in the run-up to the referendum, although if it was years ahead they would have time to develop them.

Q318 Graeme Morrice: Obviously, we are aware, if we go back to the Smith Commission, that a decision was taken not to devolve to Scotland gas and oil revenues. It appears that that was a unanimous decision. What are your views on why they took that decision, and do you think it was the right one to take?

David Phillips: One reason you might think it is a good tax to devolve is that the kinds of tax you might want to devolve are those where the tax base is relatively less mobile, because by devolving it there is less chance of tax competition. For instance, if you look at corporation tax you have the North sea element and the onshore element. Onshore corporation tax can be shifted all over the place because of transfer pricing and profit shifting, but North sea production takes place in the North sea and is less easy to move. On the one hand, that would make it a relatively attractive tax. It is fixed in Scottish waters. But—

Q319 Graeme Morrice: I thought there was a “but” coming.

David Phillips: A very big “but”. I think they did make the right decision in the context of maintaining a fiscal union. We have just been talking about how volatile those tax revenues are. They go up and down from year to year. That has two implications. First, if Scotland is bearing the risk of those revenues it would need substantial borrowing powers, and in the context of independence it would be bearing the full risk of that; no one is underwriting that debt. But as part of the UK, even if the UK Government said no to Scottish Government borrowing: “We are not underwriting it”, the markets might feel there was an implicit underwriting of that debt. It would count towards the UK Government’s borrowing targets. If the Scottish Government wanted to borrow that money they would pay a higher interest rate. If the Scottish Government had to borrow it, it would put more risk on the Scottish Government’s budget, and they would have to have borrowing powers to try to absorb it.

Secondly, it also causes problems for how you adjust the block grant. If revenues are going up and down every year, how much do you adjust the block grant each year? One of the ways it has been done under the Scotland Act, which is attractive—it is in the proposals of the Smith Commission as well—is to index it to what happens to the tax revenues in the rest of the UK, but for the North sea there just aren’t those tax revenues, and the small amount there is might be changing in very different ways given what is happening in the North sea. If they discover one new field in English waters, that could lead to a sudden big increase in revenues in England that is not happening in Scotland. How do you adjust the block grant in that situation? Because of the risks and complexities of adjusting the block grant for North sea revenues, and given the overall Smith set-up, they made the right decision not to devolve it.

Professor McLaren: Most of the economic literature on this would say, “Don’t devolve such highly erratic taxes.” Added to that is the fact that you will have to adjust the Barnett formula which, as David says, makes it seem likely, too. I suspect that the people who were negotiating at the time were not blind to what was happening to the oil price at the time. For those reasons, they probably made the economic and fiscally correct decision, but I do not think those economic and fiscal grounds are that strong. They are pushing in that direction, but they are not necessarily that strong.

That takes you back to what the other concerns would be. What does the populace think of it? What do the voters think of it? They might be a bit confused. A lot of the debate was about North sea oil and how good or bad it was, and how much it would bring in. Then the Smith negotiations completely excluded, almost from the start, any discussion of the North sea and to what extent Scotland should benefit from it, so if I was the electorate I would perhaps be confused. Maybe we will get to this later, but that was never really explained because the Smith Commission deal was a package, so each individual decision was not made. There is still an issue there.

If you look around the world at tar sands in Canada and fracking in the United States, localities will benefit from those commodities in those areas—even Shetland—perhaps not fully but to some extent. It still seems odd to have a situation where the North sea is still off-limits to any aspect of fiscal federalism. I do not think we have heard the end of what the electorate, if it can somehow put over its collective opinion, thinks of that decision.

Q320 Graeme Morrice: Would the electorate not understand it because the decision of the commission was unanimous? Obviously, there were two parties both supporting independence and arguing not just for fiscal autonomy but total independence when it came to this particular issue and everything else, but do you not think people would understand that, if it was a unanimous decision, they took the decision for the right economic reasons?

Professor McLaren: It could be said that the 85% who voted, many of whom had probably never voted before, thought they had made the decision, that a vow was made to the Scottish people and somehow it had to be dealt with. That was then taken away. Yes, a lot of people made written submissions to the Smith Commission, but essentially it was 10 people from the main political parties in a room making a decision and not really explaining it tax by tax. I do not know if they would be that happy that that was what they thought would happen. Maybe they thought what was going to happen was that they would come up with some alternatives and there would be a further referendum on different aspects of what might happen: full fiscal autonomy, what Smith has come up with, or other variants. That is another potential, but it is too early to say whether or not people are content with the Smith Commission.

Q321 Graeme Morrice: It has been suggested that there should be a referendum on the recommendations. David, you wanted to come in.

David Phillips: It was on the political economy aspects. I can see the points John is making about the reasons why you might want to devolve it. In the US and other countries where they devolve revenues more locally, they do not have this system of block grants and Barnett which interact with it and make it more complicated.

Some of the reasoning behind it may have been, “Look, we’re trying to sell the Union as a sharing union, like a risk insurance union, so we can say that there are North sea oil revenues that Scotland shares with the UK, and, on the other hand, pensions are shared across the whole of the UK and that benefits Scotland because of its older population.” If we take the recent thing on mansion tax, that works out because we’re given the oil revenues and they’re given the mansion tax in England. I think there was a narrative about a shared fiscal union—sharing natural resources, pensions, the national insurance system and things like that. That probably fed into it as well from a political angle.

Q322 Graeme Morrice: Moreover, the Smith Commission’s remit was to look at implementing the vow, and the vow did not talk about fiscal autonomy, devo-max or even neo-federalism, as has been suggested by some people.

Professor McLaren: But the vow, when it talked about the Barnett formula, did not make sense to me.

Q323 Graeme Morrice: It talked about retaining the Barnett formula.

Professor McLaren: It talked about retaining the Barnett formula to protect Scotland’s funding, which it does not do, and it said something about it being based on need, which it does not do, and then there was something else that it does not do. I could not understand that part of the vow at all.

Q324 Graeme Morrice: You are suggesting there is an inherent problem with the Barnett formula, therefore.

Professor McLaren: The Barnett formula, contrary to previous witnesses, is incredibly simple. People's understanding of the Barnett formula makes it difficult because people think it does different things, but as to the formula itself, how it works and what in normal practice it will lead to, which is convergence, is quite clear.

Graeme Morrice: I think we have an odour problem in the room.

Chair: I am sorry if I am distracted. There was a strong smell of glue, carpet tiles or paint earlier on, but that was two hours ago. We are just getting rid of it.

Professor McLaren: I've got a cold, so I can't smell it.

Graeme Morrice: It is cyanide gas.

Q325 Mark Menzies: Sticking with the same theme—oil and gas—and the outlook, there are a number of questions. I appreciate David Phillips's view. You are economists and not crystal ball-gazers, but I am going to try to take you down that line to some extent. In terms of jobs and investment, what do both of you feel is the outlook for the oil and gas sector in the year ahead?

Professor McLaren: From reports in the press, the outlook is not good. It ranges between 10,000 and 35,000 jobs lost. A number of companies are renegotiating contracts, which will mean reduced wages for those who are still employed. I think this will be an ongoing process, depending on what happens. Some people are predicting that it could go down to \$20. It certainly does not look as though it will kick back up soon. Yesterday, another OPEC oil Minister said, "We're not going to change our production quantities," so it does not look as if it is going up. The US Government predicted that oil output from the US would be higher this year than last year, and higher again the year after, so high supply seems to be here for a while.

There will be a knock-on impact on jobs, perhaps even more so on investment. Once people have decided to leave a field in the North sea—maybe the start-up costs would work against it if they moved somewhere else in the world that was cheaper—as time goes on, the infrastructure, which is already ageing and has caused major outages in recent years, could deteriorate further, which would make it more difficult to put future investment in place at a price that makes it profitable.

David Phillips: I do not have much more to add; I have two small points. There has been a focus on trying to boost oil services exports so that the know-how on working in harsh conditions in the North sea can be used to help develop other harsh condition environments, but if that investment is now less profitable because of lower oil prices you might see less investment in other countries in those areas. That could have a knock-on effect not just on the direct North sea industry but in the oil services industry as well. Some of that is also based in the Aberdeen area.

On public finances, interestingly when firms cut back on their investment it means fewer tax-deductible expenses, so underlying the OBR's forecasts for the lower oil revenues we now expect is a loss from the lower prices but a small offsetting gain from lower investment spending. That helps to flatten the figures in the short term, but it could in the longer term lead to further falls in production and revenues. There could be knock-on effects from short-term reductions in investment in longer-term revenues and production from the North sea.

Q326 Mark Menzies: Professor Kemp forecast that the lower oil price would mean that the number of probable new oil fields over the next 35 years would be more than halved from 188 to 85. With that in mind, what level of oil price is required to start to see that number of fields come up? Is it getting back to the \$100-plus per barrel, or is it something much lower?

Professor McLaren: Professor Kemp has a very complicated model which he keeps very close to his chest. I think DECC have a model as well. I have access to neither, but there are so many nuances within that that it is impossible, apart from Professor Kemp and experts at DECC, to give you a valid answer.

Q327 Mark Menzies: Professor McLaren, you raise a couple of interesting points that I would like to probe further. You raised the possibility of the oil price falling further to \$20 or \$30 a barrel. If we were to see \$20 a barrel for a prolonged or substantial period of time, say more than 12 months, what impact do you think it would have on the wider Scottish economy in the first instance? In the second instance, are we likely to see an acceleration of the mothballing of fields or even their complete closure, never to return?

Professor McLaren: I think that if it went down to \$20 people would see that as a market overreaction and, therefore, ignore much of it. I think they are more worried about how much below \$100 it is going to be. Is it going to be \$90, \$80, \$70 or \$60? That is the area people are thinking about; OPEC wants it to be around \$100, and a lot of countries in the middle east and elsewhere need it to be around that to balance their own budgets. I think it would be largely discounted, but if it managed to persist for a year like that, people might start to not discount it any more and think again, but initially I think that would be seen as a market overreaction.

David Phillips: I have nothing to add.

Q328 Mark Menzies: If we were to see oil prices staying even at the current level of \$40, give or take, what impact do you think that would have on the non-offshore sector? I am thinking now of the companies based in Aberdeen—many of them may even be multinational ones—looking at corporate mergers, where head office functions are merged, exacerbating any cost reductions those companies may otherwise have planned. What I am trying to get at is: are we likely to see on a global scale companies seeking to merge and consolidate to maintain their cash position? If so, what impact would that have on an oil hub like Aberdeen?

Professor McLaren: I do not know the industry well enough to give a very confident answer to that. There has already been quite a lot of sell-off of mature or less profitable fields in the North sea to smaller companies to extend their lives. In that sense, there has been a proliferation of smaller companies doing these things. In terms of Edinburgh as a hub, the advantage it has is that it is already there.

Q329 Mark Menzies: If I said Edinburgh, I meant Aberdeen.

Professor McLaren: I am sorry. The advantage of Aberdeen as a hub, in the same sense that Edinburgh has financial services, is that it is already there. It is in an English-speaking country with a non-volatile political situation relative to other countries. Those are all positives. Why would you want to move away when you are working all over the world anyway? It would not, hopefully, have a dramatic effect, and Aberdeen would still be a key player, like Houston in Texas.

Q330 Pamela Nash: I would like to round off the questions on oil and gas by looking at how policy could support that industry at the moment. I start off with the recommendation by Sir Ian Wood to establish a new and stronger oil and gas authority. This was widely publicised when the report was published 10 months ago, yet it is not in place. Can either of you offer an opinion on the impact of the delay in setting up that authority?

Professor McLaren: I would not have thought it would have much impact, because these things have happened regardless. These are world effects. This is a commodity that is influenced by demand and supply situations around the world, so I do not think it would have had much impact.

Q331 Pamela Nash: Perhaps my question was not very clear. I do not mean an impact on price but the ability of the British oil and gas industry to cope with the changes in the oil price.

Professor McLaren: I think they are looking at a slightly different thing: regardless of the price, how do we maximise the life of the North sea? That is a long-term ambition. It has been brought forward to short term at the minute because of the dramatic fall, but long term it will probably bounce back to some extent. North sea oil in the long term and people's interest in it will always be volatile; it will always wax and wane to some extent, but what are the incentives that have not been maximised, or the disincentives that should be reduced? That is what it is going to address, and I think it still has time to do that because it is a long-term concern.

In terms of helping the industry at the minute, what you do not want to do is rush in. This industry is used to big changes in price and huge political, economic and price volatility. It is asking for help at the minute, as it would—as all industries would in these circumstances—but if the UK or Scottish Governments are going to offer help it should not be along the lines of what will help the big oil companies, which make reasonable profits, but what will help the UK in the longer term, for example keeping the infrastructure in good condition so that later on, when things pick up, the industry can carry on and gain more export markets for onshore industries.

Q332 Pamela Nash: In that case, would you support a resilience fund, which is an idea proposed over the last few days, to be provided by the UK Government, as is done in areas affected by flooding and bad weather, to help the industry to cope?

Professor McLaren: Not to help the industry. Some companies will have problems. Some of the smaller ones may need assistance of some kind, but this is a very profitable and

well-paid industry. I am not sure how much money it needs, or who exactly needs the money.

Q333 Pamela Nash: I am thinking more about the human consequences. Maybe I am not choosing the right words. The people who work for the companies would be impacted. There is the potential for tens of thousands of jobs being lost, and local areas and local authorities will be impacted by the loss of revenue.

Professor McLaren: Those knock-on effects are more locally based—the support industries in local areas in Aberdeen, or the income Aberdeen council might get—so there could be help for a transitional period, but it is too early to tell how long this difficulty will last. If there is a resilience fund, you need to keep abreast of how deep the difficulty is and how long it will go on for, not have an open-ended commitment.

David Phillips: I would agree with everything John McLaren said. Although the oil industry is used to dealing with uncertainty in the policy environment, in price and in the political environment, it still likes certainty where possible. Some of the changes we have seen in the UK oil and gas tax regime over the last few years have not contributed to that. For example, back in 2011 a fair fuel stabiliser was announced, whereby when oil prices were high there was a higher tax rate on oil firms and the petrol duty was cut for consumers, and if the oil price fell again to below \$70 a barrel—I think that was the level set—you would start to increase fuel duties to consumers and cut down the charge to oil companies, back to the 20% surcharge that used to apply.

That policy has been, quietly, largely abandoned. There has been a small cut in the surcharge—it was announced in the autumn statement—but it is still 30% as opposed to 20%, so it has not gone back down. They have completely cancelled the fuel duty increases that were meant to take effect. IFS never thought it was a sensible policy in the first place, but it is even less sensible to announce the policy and then cancel it at the last minute, because you create uncertainty in the meantime. I think there are lessons to be learned from this. If you are going to announce policies that can smooth, stabilise or help an industry in certain circumstances, don't announce them and then cancel them, because that affects the expectations of companies and has a negative knock-on effect in future. If they know that in the past the Government have not kept to their pledges, they might doubt them in future.

Q334 Pamela Nash: Are there any levers that either the UK Government or the Scottish Government currently have which they have not used already and that could help in this situation?

Professor McLaren: At this early stage it is difficult to know how far to go. Certainly, in the longer term if there were a lot of job losses and they were concentrated, you would try to put in place retraining of the work force, or make efforts to improve re-employment prospects, but that is some way down the line. It is difficult to judge at the minute how many of these people, who are probably fairly highly skilled, would find other jobs anyway and possibly would move away from the area.

David Phillips: I agree. It is early days at the moment. We need to see how long these low prices are sustained, and how flexible the local economy is in responding. A large

proportion of the workers, even if they are based in Scotland, are actually from outside Scotland—whether from England or the rest of the world—and, if they move, it means a smaller local impact on the number of workers who need retraining. They have different kinds of effect. It might mean a bigger loss of income tax revenues, which could affect the Scottish Government's budget. We need to see how this plays out before designing a policy to deal with the problem.

Pamela Nash: A resilience fund would do it.

Q335 Chair: That finishes the section on oil. As I indicated to you earlier, we give you the chance to add any comments you want to make on the issue of oil. Are there questions on oil you think we should have asked that you have prepared answers for, or should we just move on to Smith?

Professor McLaren: The fall in the oil price is concentrating minds at the minute, but we should not forget the production aspect of things, which has been declining since 1999 at quite a rate. This is to do with the Wood review and stuff like that. There is nothing we can do about the price, but you can do something about production prospects, so we have to keep the UK and Scottish Governments focused on how to maximise production, profits and employment in the longer term, and do whatever they can to keep production as high as possible.

Q336 Chair: Thanks. Perhaps we can turn to the Smith agreement and ask whether or not you believe it represents substantial new powers for Scotland.

David Phillips: Yes, I do. If you look at the proportion of tax revenues that the Scottish Government will be raising, it is an increase to just over half of all their spending being funded by their tax revenues, if you include business rates which are already devolved. That will be much higher than it is now. It is only about 14% at the moment, and it is 25% under the Scotland Act 2012. They are also gaining fairly substantial powers over welfare: not only the things that are being fully devolved—the disability benefits—but also the housing element of Universal Credit and top-up powers for other benefits. It is definitely a substantial increase in powers. However, as I said in one of our recent reports, it is a long way from devo-max, and it could be seen as a long way from effective home rule for Scotland, which was a term used in the run-up to the referendum. There are substantial new powers, but it is not home rule and it is not devo-max.

Professor McLaren: There is considerable extension of the powers. However, at the same time the Barnett formula is still in place, so the sum Scotland is getting is the same and the adjustments will be made. The reality is that the funding level is the same. Perhaps over a period of time things will change and decisions will be made, but it is a very smooth handover, if you like; it is not a dramatic change in Scotland's finances, but in terms of where they are raised and who has control of them, that power has been given. As to income tax, nobody has used the 3p that has been there since 1999. Whether people will use these powers to change it versus the UK is a moot point, so it may not lead to that much change in actual behaviour.

Q337 Chair: You mentioned the smooth handover almost in pejorative terms. It reminds me of the Chinese curse, “May you live in interesting times.” Presumably, a smooth handover and transition is to be welcomed. You do not want a big break; you want to have as smooth a handover as possible and then divergence, depending upon policies. Surely, that is the best way to do it.

Professor McLaren: You want a smooth handover, yes, but if the Government want to make their own policies and have a lot of control over how they tax their population, they has one: income tax. There is a lot of money there, but it is a single tax. You could make a big difference by changing that income tax a lot, but if you had a broader spectrum of tax powers you could start to create a much more different tax structure in Scotland than elsewhere. It would be a lot more complicated. I am not saying that one is better than the other. Yes, there is more devolution of powers, but not necessarily so much devolution of the ability to create your own tax structure. I am not putting that particularly well. Do you follow me?

Q338 Chair: I understand that, but you have now gone to a different point, which is not quite the point I raised about a smooth transition. Whatever powers you are transferring, it seems to me that you want to have it done as smoothly as possible. Therefore, making an assessment, with divergence coming later on, is much better than just a cliff-edge approach.

Professor McLaren: You can still have a smooth transition and it can lead to, “We have a variety of powers. Let’s think about what we want to do with this and that power,” whereas you could have a smooth transition with a very narrowly based power.

Q339 Sir James Paice: Given the overall decisions and recommendations of the Smith Commission about taxation, is it your view that their proposals are the right ones in terms of the devolution of tax responsibility? Do you think they should have added others, or not included some that they have?

David Phillips: That is a very tricky question. Perhaps we could start with some of the taxes that were not devolved and talk about some of the reasons why that makes sense. We have talked about oil tax regimes.

Sir James Paice: Let’s put that to one side.

David Phillips: Look at onshore corporation tax. They made the decision not to devolve that. Apparently, that was agreed quite early on; there was quite strong backing for that from across civil society in Scotland. Why might you not want to devolve corporation tax? It is one where there is particular scope for avoidance and profit shifting, and there are real complexities in cross-border issues which can cause hassle for businesses. I think they made the right decision not to devolve that, at least unless there is a more fundamental rethink about how corporation tax should be done across the whole of the UK. Incidentally, in the way it was devolved to Northern Ireland all of these issues have not been thought through in quite as much depth as they should have been.

National insurance was not devolved. Here, the reasoning was that there is a strong link to the welfare system, to pensions in particular. I do not have a huge amount of sympathy for

that view. The links nowadays between national insurance contributions and benefit entitlements are really weak. In effect, national insurance is just another tax on earned income, so by not devolving that but devolving income tax, you now effectively have one tax on income that is devolved and one that is not devolved. One thing IFS recommended was merging income tax and national insurance. That is not so easy to do now that they are in different Governments' hands. There are some questions around that.

VAT could not have been devolved because of EU rules on things here. I guess there are similar rules on duties, so there are clear reasons there.

Looking at income tax itself, the UK is quite unusual in devolving income tax in its entirety to sub-national level. Most countries that have devolved income taxes have a federal income tax and then local or state income taxes on top of that, so the UK is quite unusual in that respect. There is a reason why they did that. It was probably the right decision, but it is a bit nuanced. The reason they devolved the entire tax is that the Government may change the tax rates. Say the Scottish Government decided to put up the tax rates, and you've devolved half the tax. The top rate was 22.5p in London and 22.5p in Edinburgh for the 45p rate. The Scottish Government put up their tax rate to 27.5p to give a 50p tax rate, which is one of the points of the proposals. That raises revenue directly, but it also has a behavioural effect. If you have a higher tax, people will respond. They move or they reduce how much they earn, and so on. That reduces tax revenues in Scotland, but if you devolve only half the tax to Scotland, Scotland bears the revenue costs on its 27.5p of the tax but the UK Government sees a loss of revenues on its 22.5p of the tax, even though it hasn't changed its tax policy. It skews incentives for the devolved Government if you devolve only part of the tax. If you devolve it fully, they bear the full behavioural effects of the change as well, so you do not have these skewed incentives against cutting taxes. Therefore, it makes more sense to give the Scottish Government the correct incentives and devolve income tax fully. Wales will have the power to vary rates individually, but it is only keeping the top 10p band. It could face distorted incentives. Scotland won't now, because of the full devolution.

On the other hand, I have talked to economists in America. They do not worry about these distorting incentives. Their main concern is tax competition, so they see this distortion, where you do not bear the full revenue costs of tax increases and you do not gain all the behavioural effects of tax cuts, as a good thing, because it stymies the race to the bottom that you might get otherwise.

It is a bit nuanced, but probably they were right to devolve income tax fully. There is a question about what should happen to dividends taxation, because if you have different rates of tax on dividends from those on earned income in Scotland it opens up new opportunities for tax avoidance.

Q340 Sir James Paice: One of the questions I was going to ask was whether there was room for people at the higher earnings end to adjust their tax affairs, for want of a better expression, given that income tax is devolved but dividend tax is not.

David Phillips: That is a real possibility, particularly for directors of closely held companies—owner managers of small businesses. Rather than being self-employed, there could be an incentive to incorporate and then pay yourself dividends if they are to be taxed at a lower rate. You might pay less in salary and more in dividends. That means there are

probably more avenues for behavioural response if Scotland has a higher tax rate than there would be if the tax rate was higher in the UK as a whole. Evidence from HMRC suggests that the 50p tax rate for the UK as a whole did not raise much revenue, because people responded by cutting income, shifting income and so on. The fact that the Scottish rate will not apply to dividend tax makes it even more likely that the behavioural effects will mean that the top rate of tax does not raise much revenue. It certainly gives big scope for avoidance.

In summary, I think that in general they made the right decisions. Some of them they could not devolve for technical and legal reasons. Some of them are not particularly good because they are so mobile. Did they do it correctly for income tax? It is not clear. It is unusual to be devolving it in full, but there are benefits in doing that. The issue around dividend tax is that clearly it means more avoidance, but I have been told by accountants and lawyers that it is harder to devolve that part of it.

Professor McLaren: One of the problems with the package is that you accept the whole thing; you do not go through it one by one and say, “That’s why we did this.” I read Lord Smith’s evidence to you of a few weeks ago. He said that some things were immediately on or off the board. There was no discussion about economic merits or anything like that; it was just, “Well, we know that’s not going to happen, but we definitely want that.” I think it makes it more difficult to persuade people in general that it is the best package when you cannot go through it and say, “So you all agreed about North sea oil taxes”—“No, we didn’t.” Two parties clearly wanted it and the others did not. As part of the package you do not get it. As to corporation tax, two parties clearly wanted it; the rest did not, but it was part of the package. It is a package, but not one that has been agreed point by point, and that perhaps could lead to issues further down the line. I do not know whether or not this is a good analogy: the euro was mainly a political deal rather than all the economists agreeing that it was the right thing to do and it was the perfect structure.

Things could unravel, perhaps in the adjustment processes that we are going to discuss later, as a result of that. To my mind, that is still the main area where it can be criticised. I agree that it is a big achievement to get a deal between all these parties. However, if you cannot all agree, as you do not, on that package when you break it down bit by bit, it could lead to problems further down the line. Corporation tax is a perfect example. They knew Northern Ireland was about to get something in the autumn statement, but they still went ahead and said no. We have evidence from people in the public sector in Scotland saying it wouldn’t be a good idea. I imagine there is quite a lot of evidence from people in the public sector of Northern Ireland saying that it was a good idea for them. The Treasury have agreed to it, so they think it is a good idea. There are some slight differences, but they are not huge in terms of having Northern Ireland as a land border.

David Phillips: To some extent, an explanation of the rationale behind choosing the taxes is what is lacking in the Smith Commission. I am not sure whether that was purposeful, in the sense that they were presenting it as a political package and deal and therefore they did not want it to be unpicked by providing that detail, but it is in sharp contrast to the Silk Commission, the Calman review and the Holtham Commission, all of which published very detailed analyses of why they came to their conclusions about specific taxes and areas of spending. Maybe that is one of the drawbacks when you do something to such a

quick political timetable; you do not actually get to look at all the economics behind it as well.

Q341 Chair: But surely, if you think of EU negotiations, they always go right up to the wire, so you do not have a deadline. The danger is that you end up never getting an agreement. Surely, John, the whole point of a package is that people accept things they would not otherwise accept because they are getting something else. Nobody, as far as I am aware, got everything they wanted out of the agreement. That is in the nature of a compromise. I am not quite sure what you are saying, because you would not have got an agreement had people not been prepared for a bit of give and take.

Professor McLaren: There are two aspects to that. One is that you can say this is the package and these are the things that have been included and excluded, and these are the reasons for it. Perhaps not everybody would agree with those reasons, but you can still put them forward and say the majority view was that corporation tax was not included because of such and such. That is one aspect.

The second aspect is what I said before. You do not have to tell people what is going to be. You can then ask them what they think of some options and have a further referendum, or a further stage of consultation, which says, “We’re thinking of something like that.” For example, of the many thousands of submissions to the Smith Commission, which are supposed to have been taken on board to some extent, I have no idea how many said there should be full fiscal autonomy; and how many said corporation tax should be included or excluded, or that North sea oil revenue should be included or excluded. Is that relevant? If it is not relevant, why did people send in the submissions? If it is relevant, how was it taken into account? These sorts of things are not explained anywhere in the Smith agreement, and I think greater transparency would have been beneficial.

Q342 Chair: Would you not accept the argument that, in the run-up to the referendum, commitments were made about a timetable? While I understand your point about further consultation, had they then decided, “We’re abandoning the timetable we previously put forward in order to have further consultation,” that would have been denounced as a betrayal. If you make the commitment that you are going to bring forward something within a certain time scale, with legislation by, I think, the 25th of this month, you have to abide by that, and that rules out to some extent the further process of consultation that you are looking for. It is a bit like a neverendum in a sense, isn’t it?

Professor McLaren: No, because that would only apply if somebody objected to it. If the parties who said, “We must stick to that time; it can’t shift,” refused to take it back as another referendum and said, “No; it’s going to be done by us in this closed room and we don’t care what anybody else thinks,” it is up to them; they can go ahead and do it. But if they were to say, “Yes, overall. We still want to move it as fast as possible, but we want to refer back to the electorate a bit more to see what they think of what we in these closed four walls have been discussing,” I think that would be accepted.

Q343 Chair: Presumably, the argument would be that we have a general election coming up.

Professor McLaren: This goes back to a fundamental point. Was this rushed? I think it was. We have an agreement in a short space of time. Is that a good or a bad thing? Time will tell.

Chair: Indeed.

Q344 Sir James Paice: I want to go back to income tax. David, you talked about the complexity of corporation tax. Do you feel that the complexity of a different income tax rate in Scotland from England is an issue, given that people work all over the world, are taxed in different places and their companies are based in different places, or has computerisation resolved it?

David Phillips: The issue of rate differentiation between England and Scotland does not add to the complexity that much. Having different rates is not very complicated. Clearly, it can cause a behavioural response.

Q345 Sir James Paice: I am talking about the complexity of bureaucracy and administration.

David Phillips: But behavioural response can sometimes cause administration problems. If somebody has an incentive to say, "I'm living in England because I get a lower tax rate," because, say, there was a 50p rate in Scotland, you have to have a mechanism in place to work out whether they are living in England. Are they satisfying the rules? A set of principles was agreed when they initiated the original 1998 Scotland Act. We know how to define these things, but implementing them in practice becomes more difficult when you have different tax rates because there are incentives for people to lie about it. You have to check that they are telling the truth, but the difficulty in having different rates is pretty low. There would have been more complexity if there had been different definitions of income and a different tax base, as opposed to tax rates, between Scotland and the rest of the UK. Clearly, that does happen around the world. Most countries have slightly different tax rates from one another. It is not insurmountable, but that would have added substantially more complexity. Given the closer integration between Scotland and England than the UK and the rest of the world, keeping the same tax base has probably simplified things.

Q346 Sir James Paice: The only other question I want to ask is the reverse of everything we have been saying. Do you think that what Smith recommended for Scotland is the right balance for the rest of the UK?

David Phillips: I have two answers to that. The first answers Ian Davidson's question about the Smith process as well. Given the vow and the timetable, my personal view is that that had to be kept to; otherwise, it could have been used as a stick to beat the UK Government. I think Smith did an admirable job of looking at a very difficult issue, but it is not good to change the fundamental structure of a fiscal system across the Union in 10 weeks using representatives from only one part of the Union. That is fundamentally what has been done. The change to the way the UK fiscal system works has been rushed, and it has only been thought about in the context of one country. I am not sure that the specific taxes being devolved are the real issue; it is more whether the process is being fair to

England, Wales and Northern Ireland, although there are some issues around specific taxes. I guess that air passenger duty is one you would have in mind in relation to Newcastle airport. The Welsh Government want air passenger duty as well—for example, Cardiff versus Bristol airport. The Welsh Government have been pushing very strongly to have those powers now that Northern Ireland and Scotland have them. It does seem kind of hard to deny that now.

The other issue is not so much about fairness to the rest of the UK in the way taxes have been devolved, but how the block grant is adjusted. It would be unfair if the block grant is not adjusted in the correct way. That could mean that the rest of the UK ends up losing out because Scotland is getting its own revenues and it is getting money under the block grant, which has not been properly adjusted, or that Scotland loses out—vice versa. There is an issue about fairness to the rest of the UK and to Scotland in each of the proposals, and how we implement the proposals on indexing the block grant reduction appropriately. To me, that is where some of the biggest implications for the rest of the UK arise.

Professor McLaren: The average taxpayer probably will not notice an awful lot. I do not think it will have been welcomed by the Treasury, quite apart from the fact that they have to implement a lot of it, which is fairly vague at the minute. In particular, going back to David's point about the adjustments, it makes it more difficult for the UK Chancellor to change income tax. It does not matter what he spends that money on; it has an impact on Scotland. It does not matter whether it is a devolved service—defence, pensions, changing from less income tax to more VAT, or borrowing. Each of those has an implication for Scotland, which means that, if Barnett still applies, you have to make a deduction from the Scottish block if you increase income tax, no matter what you spend it on, or an addition to the Scottish block if you reduce UK income tax, no matter what you spend it on. That could lead to vigorous political debate, which may mean that the Chancellor finds it difficult to use income tax to change spending, unless it is for certain things. I do not think that the public or even academics have gone through this very much, but it could have quite serious knock-on consequences.

Chair: We have to adjourn because we are being summoned to a vote. We are enjoying ourselves that much that we will come back as soon as we can.

Sitting suspended for a Division in the House.

On resuming—

Q347 Mr Reid: One part of income tax that was not devolved was the ability to vary the personal rate. Is there a way for the Scottish Government effectively to increase the personal rate by setting a zero rate?

David Phillips: Yes. I will give the same answer that I have given twice before to this Committee. They could set a zero-rate band. In effect, they can increase it but not decrease it. It does have one other implication. In 2010, the last Labour Government introduced a policy where the personal allowance was tapered away for people with incomes above £100,000, so if you had more than £120,000 you had no personal allowance. That would not automatically apply to any additional zero-rate band that Scotland set. If you wanted to continue tapering that away, you would have to set an additional band, a 60% band for the

range of income you are trying to taper it away from. It might seem a bit strange to people to have a 60p band of tax sitting in the tax system.

Q348 Mr Reid: It would then revert back.

David Phillips: It would revert to 40p and then back up to 45p. It is a weird stegosaurus graph. It is not just that; there are other implications. The only difference is that, if they devolved it, the question is whether they could reduce it as well. They already have the interaction with the tapering of the personal allowance. Having said that, I cannot see a good reason for not devolving it. It is not one of the complicated things that interact with the tax base we were talking about earlier.

Q349 Mr Reid: You referred to interaction. How would it interact with tax credits, or Universal Credit when it comes in, if there was either a zero rate, or a rate lower than 20p, for the initial taxable income? How would that interrelate with tax credits or Universal Credit?

David Phillips: There is an interaction. Under the current system of tax credits, for instance, tax credit entitlements are based on your gross income, so any changes to income tax rates do not affect what you get in tax credits. However, Universal Credit will be based on your after-tax income, so once Universal Credit is in place, if the Scottish Government cut income tax rates, that means your net income has gone up and you are entitled to less Universal Credit. Vice versa, if they put up tax rates, your income goes down, so you are entitled to more Universal Credit. There will be an interaction between the tax rates the Scottish Government set and how much it will cost the UK Government to implement Universal Credit in Scotland. That interaction between the tax system and welfare, or welfare-to-work programmes and welfare spending is one of the reasons why the UK Government are quite keen to have the parties compensating each other for any revenue costs or gains imposed.

Q350 Mr Reid: Let me get this right. If the Scottish Government were to have a zero rate, or effectively to increase the personal allowance, the individual would lose Universal Credit.

David Phillips: Yes.

Q351 Mr Reid: Would the UK Government have to compensate the Scottish Government?

David Phillips: In the first round, the UK Government would be saving on Universal Credit, and then the principle under the Smith Commission is that in those circumstances negotiations should take place, or arrangements should be in place, for compensation to occur. That is an example where you might want such compensation. Working out how much compensation to give will be very difficult. If you see Universal Credit expenditure in the UK fall because of this policy change, how much of the fall is because of the policy change and how much is it because of other underlying changes in the economy that may also reduce Universal Credit expenditure? You would have to model the impact of these changes, which can become quite complicated. The assumptions you make can have big impacts, and there can be room for disagreement.

Q352 Mr Reid: The straightforward calculation I was thinking of was that the DWP would know how much Universal Credit they had paid the individual. They would also know how much Universal Credit they would have paid the individual if the tax rate was the same in the rest of the UK. Would that straightforward calculation work, or would it be more complicated?

David Phillips: You can do those kinds of straightforward calculations. Let's say another example of the effects of this policy is that you have a high personal allowance, so people have more incentive to go into work, and people work more in Scotland. That also reduces Universal Credit expenditure by the UK Government. You can take into account the mechanical effects relatively straightforwardly, but you cannot take into account the behavioural effects. The problem about doing only the one is that you might skew the incentives. Imagine that this tax cut leads to big numbers of people moving into work in Scotland. For the Scottish Government to take the right decision on that, they should be gaining the benefits of those people entering work. In working out the compensation, you want to take into account that part of it. The difficulty comes in working out the behavioural effects, because you can have different assumptions in your modelling that lead to quite different results, and there is scope for big disagreement. If they devolved Universal Credit spending, it would solve the issue, because it would be automatically worked out. Scotland would be paying for it out of its own budget. When you devolve some things but not others, you have knock-on effects. Working out compensation can be difficult and potentially can lead to disagreements.

Q353 Mr Reid: Would a model need to be set up? Presumably, there would be an attempt to agree the computer program or the model.

David Phillips: Two things need to occur. First, the principle of compensation already exists under the current devolution arrangements. If the UK Government make a spending or tax decision which affects the Scottish Government's spending demands, the UK Government should compensate them. From talking to people at the Treasury recently, it has been used once or twice; it has been very rarely used.

In the first instance, there would need to be an understanding that these compensating arrangements can be used only in a few circumstances where there are obvious costs or benefits, and you can get agreement on what they are. Nearly every policy decision that the Scottish Government or UK Government make will have knock-on effects for each other. Let's go back to the earlier example—putting up the top rate of tax to 50p. That could have knock-on effects for the UK. On the one hand, if they put up the top rate to 50p and people work less in Scotland, it does not just mean less income tax; it means less national insurance, which is a UK tax. Should the Scottish Government have to compensate the UK Government for that lower national insurance? On the other hand, those people might shift their income into dividend income, which is a UK tax so the UK Government gain money. Should the UK Government compensate the Scottish Government? These things are very complicated and they arise all over the place. Because there are so many different things to model, getting an agreed model will be very difficult. Expectations should not be raised too high that these things can be done in every single circumstance, that every single policy will be assessed to see the knock-on effects and then they will all be modelled, because that quickly becomes impossible and leads to the whole system grinding to a halt. There will have to be an understanding by both Governments

that they have to work together in good faith, and only in a small number of circumstances will they have to deal with big knock-on effects. There will be some where Scotland gains and some where Scotland loses, and vice versa. The small ones will probably cancel out over time. Only deal with the big ones where you can have a good go at modelling those things; otherwise, it grinds to a halt.

Q354 Chair: In response to Alan's point, you referred to Universal Credit and so on. Presumably, it would be possible for the UK Government to say they would undertake to ignore any income tax changes in Scotland from the point of view of calculating Universal Credit, so that people would not, if they had their tax cut, then lose Universal Credit. It would be as if that change had not been made.

David Phillips: That is potentially quite difficult because Universal Credit is designed to work on the basis of net income. That means you take into account the taxes people pay. If you say it is to be based on net income but you are not taking into account all the changes in the tax system, you have a strange hybrid system, which is based partly on net and partly on gross income and it becomes quite complicated. It could potentially break one of the aims of the Smith Commission, which was that there would be a common Universal Credit system across the UK. If you do this, in practice the Universal Credit will be different across the UK because its base of operation—the tax base—will be different in different parts of the UK.

Professor McLaren: I have a couple more generic points in terms of models to work out these impacts. The trouble with a model is that it gives you the answer depending on the assumptions you fed into it in the first place. There could be a Scottish model and a UK model, which takes you back to the whole thing about needs assessment: I think this is the right variable to use and you think that one is right, so it is subjective rather than objective. There will always be problems on that side.

We are talking about one event. After 10 years it will be that, that and that, and trying to follow it through will be almost impossible. The idea of keeping it as simple as you can—yes, there will be swings and roundabouts and you can complain about it, but that is to your benefit—is probably worth sticking to as far as possible.

Q355 Pamela Nash: I would like to concentrate on the devolution of welfare as set out in the Smith agreement, but also those parts of welfare which were not in the Smith agreement, and the opportunity in the agreement for the Scottish Government to provide new benefits. What do you think are the possibilities for that, and how might the Scottish Government use those powers in future?

David Phillips: The area that has been devolved is disability benefits, although not entirely, because Universal Credit has the ESA component mapped on to it. The commission did not say what it proposed to do with contributory ESA, which is not mentioned as being reserved or devolved, so maybe there is a need for clarification of what it intended to do in that respect. The Scottish Government have full powers over that. They could choose to redesign the system of support for disabled people; they could choose not to go ahead with the shift to personal independence payments, as is happening, or undo that change if it has already occurred by the time these powers are devolved. They could change the system entirely. They really have carte blanche in the area of disability

benefits policy to change things, or perhaps integrate it better with social care in Scotland, which was one of the reasons why all the unionist parties agreed attendance allowance could be devolved.

In other areas they have power over the housing element of Universal Credit. Interestingly, it is not clear whether they will have power over housing benefit if Universal Credit is not fully rolled out by the time these powers come into place. The new forecasts from DWP have Universal Credit still not fully rolled out in 2020; there will still be people on the existing legacy benefits at that point, including housing benefit. Will they have power over housing benefit as well as the housing element of Universal Credit? They could make changes there.

Interestingly, one of the things the proposals do not deal with is the link between social housing and housing benefit. One of the things the Scottish Government said was that under the current system Scotland spends more money on social housing than is spent in the rest of the UK. Social housing is cheaper to rent, and therefore that means lower housing benefit bills, which the UK Government benefit from because they pay housing benefit. You might think that devolving the housing elements to Scotland solves that issue, but it does not, because the plan, as I understand it, is to devolve the power to vary the housing elements but not the spending underlying it. If they spent more on social housing, which reduced rents and therefore meant lower spending on the housing element, the UK Government would still pocket that. The Scottish Government only pay for or pocket any changes that link directly to the housing element of Universal Credit, so devolving it has not dealt with some of the problems that were identified—some of the reasons for devolving the housing element—although of course it deals with problems like discretionary housing payments and the abolition of the spare room subsidy/bedroom tax.

In other areas they can do top-ups to benefits, as I am sure everyone is aware. I think it has been reported to the Committee that that means that the only power they do not have is to cut benefits. I am not sure that is the case. I think it also means they do not have the power to change the structure of the benefits. They can add top-ups to the rates of benefits, but I am not sure they can change the eligibility criteria, the taper rates of Universal Credit—the amount by which they reduce Universal Credit as your earnings increase—or whether the top-up powers only apply to the underlying benefit rates. My understanding at least is that they have power to top up, but they do not have power to change the structures and taper rates or to reduce benefit rates.

Q356 Pamela Nash: Professor McLaren, what are your views on what has been devolved as part of the Smith agreement? To what extent do you think these powers offer flexibility? Do you think they offer what the Scottish people were looking for from the Smith agreement?

Professor McLaren: The most interesting thing about welfare in terms of the Smith agreement was the role of Universal Credit. If Universal Credit had not existed, what would have happened? Because it exists, everything is taken off the table because it was a no-go for certain participants. That takes almost everything off the table. It could still come back on if a future UK Government decided that Universal Credit technically did not work, or if a future UK Government decided they did not like it and wanted to split it up again. Would there be another commission to revisit it, because at the minute it is predicated on the fact that there is Universal Credit? If it is not working in England, there might be more pressure in Scotland to say, “This is not working and we want to do our

own thing.” Because Universal Credit is there, it was off the table, so there was very little debate, even within civic Scotland, about what should or should not come to Scotland, because it seemed to be accepted that it would stay as it is. That is one interesting aspect.

In terms of what might happen, the most interesting thing is that they can add things. Somebody gave the example that, if you wanted to, you could hugely increase the winter fuel allowance. You could say it was like an extra pension top-up, which I think is technically possible.

David Phillips: It is technically possible. I think you can use the top-ups even to increase the state pension directly. There is no reason to do it via the winter fuel payment.

Q357 Chair: I think that view about topping up the winter fuel allowance was put forward on the basis there was some doubt about whether or not you could technically deal with the state pension in that way. There was another way round it, which was identified as topping up the winter fuel allowance so that it applied even in the summer and every week.

Professor McLaren: That would be very messy. You can see how, coming up to an election, some parties might try to put forward popular policies, and because there is proportional representation in Scotland some of these things might be taken forward. There are obvious dangers—for example, cost. All of this is on the assumption that things are going to go up, and obviously the reverse applies. If it becomes particularly attractive, you start getting benefit migrant-type impacts, potentially with disability and other areas. If pensions become a big differential, people might start to think seriously about moving there. Because there are not many people on the border between Scotland and England, people have to make quite a big shift, which is handy. If it was Wales, it would be much more complicated than moving just a few miles over the border in south Wales.

Although Universal Credit took a lot off the table, potentially a lot could still be done, but I have heard very little from political parties about how they intend to change anything. That is a running theme in this. All these powers would be great. How would you change it? I have heard about a 3p reduction in corporation tax. Other than that, which is not part of the Smith Commission, there are not an awful lot of ideas about how to radically change the tax and spend system from what it currently is.

Q358 Chair: My view, and I think the view of the Committee, is that the powers being offered in Smith, if implemented, would allow a future Scottish Government to double every benefit existing in Scotland. That would certainly overcome your issue with tapers, because they could decide to add to the taper rate whatever sum they wished.

David Phillips: No. I could be wrong—it is not specific in the Smith Commission proposals, and my discussions with the Treasury have not gone on to this aspect yet—but my understanding is that the top-ups relate to topping up the benefit rates. I could make Universal Credit £200 a week rather than £100 a week, but one of the things that is reserved in Universal Credit is the taper rate. For every £1 of income I earn, by how much is my Universal Credit reduced? If you were to devolve Universal Credit fully, you could have a maximum of £200 but withdraw it more quickly as your income rises. They cannot do that under this system. If they increase the maximum amount, they still have to

withdraw the same amount as before. They can increase the maximum amount of Universal Credit you can get, but they cannot change how you withdraw that.

Q359 Chair: Since the objective would be to affect the amount of money people receive by topping up, give me two minutes and I could find a way. You could say that anybody who was entitled to Universal Credit of anything between £5 and £10 should have their Universal Credit increased by the Scottish Government by £50; anybody who is going to get £20 to £30 should have it increased only by £10. That destroys the taper completely, doesn't it?

David Phillips: You are saying that you can circumvent it by having a very specific top-up. Rather than topping up the overall rate, I'll give you an extra £10 if you have zero income and an extra £20 if you have £50 income. Potentially, that becomes a lot more complicated to implement.

Q360 Chair: In lots of these things, in a sense we are not so concerned about the detail of implementation. People in the streets of my constituency are not discussing the bureaucratic niceties of implementation, but we are discussing the general principle. I think the general principle is that, if the Scottish Government choose to double, treble or quadruple any benefit, they would have power to do so,

David Phillips: Yes.

Q361 Chair: To that extent, they would have complete power to affect the welfare system, since by a combination of differential increases they would be able to produce a whole host of solutions that they wished to implement.

David Phillips: What is not clear to me is whether they can do these differential increases.

Q362 Chair: If I remember correctly, clause 54 gives them the power to make discretionary payments on any benefit they wish. It also gives them the power to create any new benefit they wish.

David Phillips: I thought the power was to create any new benefit in areas of devolved responsibility, which is disability benefit and the housing element.

Chair: It is the pantomime season: "Oh, yes you do." I am just looking to see whether somebody has that to hand.

Q363 Pamela Nash: It is in the areas that have been devolved that they can create other things.

David Phillips: The devolved benefits are basically disability benefits and the housing element. I do not think they can create a new pensioner benefit or a new Universal Credit-style benefit.

Q364 Chair: I must say that is not my reading of it. My reading of it was that it was intended to allow for the creation of any new benefit that the Scottish Government wished.

David Phillips: My understanding is that it would allow them to create any new benefit they wished in the areas of benefit that have been devolved.

Q365 Chair: We will have to look at that.

David Phillips: On the point about discretionary benefits, I think the term “discretionary payment” is a specific technical term which relates to payments like discretionary housing payments. It does not mean that the Scottish Government have discretion to design the system in any way they want. I think that “discretionary benefit” was used as a technical term, and is about the Government using their discretion in individual circumstances about whether to grant a benefit to someone. For instance, with discretionary housing payment the local authority says, “We have an application. They say they cannot afford to buy a new cooker this month. Can we give them some money to do that?” I think that is what they mean by discretionary payment, but you should check with the Smith Commission whether that is correct.

Q366 Chair: In the dialogue we have had with everybody else, the term “discretionary” was used in the context of normal people speaking, as distinct from DWP experts, as it were. Discretionary means something where you have discretion rather than having your particular meaning. We read, “The Scottish Parliament will also have new powers to make discretionary payments in any area of welfare without the need to obtain prior permission from DWP,” as meaning they can do basically what they like. When we put that to Lord Smith, he did not demur.

David Phillips: I read the transcripts of the previous evidence sessions. Someone did mention the point about “discretionary” being a technical term. I am not sure whether it was the person who came along with Lord Smith—the person from the secretariat to the Treasury. Maybe clarification is needed. It is only my personal reading, but I read it as meaning that they had power over benefits in devolved areas, and, according to the technical definition of discretionary, they could make discretionary payments in any area.

Q367 Chair: The first sentence of 54 reads, “The Scottish Parliament will have new powers to create new benefits in areas of devolved responsibility.” Further down in 55 it says, “Any benefits or discretionary payments introduced by the Scottish Parliament must provide additional income for a recipient.” That relates to the point about Universal Credit clawing back or not clawing back. The intention was that, if it produced additional benefit, the assumption would be that it could be clawed back. Therefore, people in Scotland who benefited from any of these rules would be better off in overall financial terms, since that was the object of it, rather than having any gain clawed back.

David Phillips: There are two points. I was going to come to the second point a bit later. That happens automatically in nearly every benefit, because most benefits do not count towards the income tests for other benefits or towards income tax. It is more problematic in the case of state pensions. The state pension is taxable. If you had an additional Scottish

top-up of the state pension, this implies that it should not be taxed. That could be complicated for HMRC.

Q368 Chair: But HMRC would not tax pensions as income because they have devolved income tax.

David Phillips: But HMRC is operating the tax system, and as it stands the standard pension would be taxed and this additional part would not be taxed.

Q369 Chair: Presumably in those circumstances the Scottish Government, working on the basis that the HMRC system cannot differentiate between Scottish and UK taxpayers, will increase it by an amount that allows for the amount that it will be taxed in order that people will get the net increase it desires.

David Phillips: Yes, or that could be the reason why they suggested it in the winter fuel payment, because that is not taxable. Maybe that is the reason why they suggested doing that. There are also issues about the state pension to deal with. If you do top-ups to the state pension, how do you define who gets those? Is it based on residency in Scotland at the time they are pensionable or based on where they were living beforehand, or things like that?

You made a point earlier about where they have discretionary powers. To me at least, when it says “any new benefits or discretionary payments” it reinforces the fact that it is the technical meaning of discretionary—like a discretionary housing payment or a discretionary social fund payment—as opposed to discretion over what you do with benefits. My reading of this has been that they have powers for any benefits in the devolved areas. They can top up in other benefit areas. I am not entirely sure whether or not they can actually say, “We are going to top up differentially for different types of people,” because that could be seen as changing the fundamental structure, like the taper rate which has supposedly been—

Q370 Chair: That is the point of devolution.

David Phillips: Indeed. I agree that when you devolve things you give a power, but they seem to have wanted to reserve some of the powers here and not to devolve them, and they will also have the power to make these discretionary payments to individual claimants. That is my reading. Maybe others have interpreted it differently.

Chair: We will obviously have to go off and clarify that. That is a valuable point.

Q371 Mr Reid: I want to probe on that subject. By discretionary, do you mean that the Scottish Government would have to assess each individual’s particular circumstances? Would they be allowed to have a policy or a formula? For example, could they have a policy that everybody who is referred by an agency to a food bank automatically gets an extra £50 in benefit? Is there a formula that would make that possible or would they have to individually assess?

David Phillips: I do not know that technically a formula would be possible. If it is similar to discretionary housing payments, what happens in that circumstance is that local authorities get requests for discretionary housing payments and they then assess them against a set of criteria. There is a formulaic element. They assess them against a set of criteria but they have to assess each individual one. It is not a calculator; it requires discretion.

Q372 Mr Reid: But they must have a formula that they put into a computer, and that formula automatically—

David Phillips: Any discretionary housing payments are not then seen as discretionary because the formula is seen as deterministic.

Q373 Mr Reid: Yes, but if the Scottish Government decide, to use the food bank example, that everybody who is referred by an agency to a food bank is deserving of more benefits, and therefore should automatically get a fixed amount extra as a one-off payment, would a formula like that come under the discretionary scheme?

David Phillips: I am not entirely sure. You would have to check with the DWP about the rules. It is not how they currently generally work. Maybe it would be possible, subject to negotiation.

Q374 Chair: I want to raise one point with you. Discretionary housing payments are now being given to everybody in Scotland who is liable to pay the bedroom tax. The discretion there has been exercised in favour of everybody, which would tend to indicate that they are not discriminatory.

David Phillips: Yes.

Q375 Chair: Does that not to some extent undermine your case? Presumably anything that is discretionary cannot be universal.

David Phillips: I understand that special dispensation was given to the Scottish Government to apply that. That goes beyond the normal rules.

Q376 Chair: Clause 54 says, “without the need to obtain prior permission from the DWP.” Presumably in those circumstances agreement can be taken as read.

David Phillips: Perhaps. That is an issue for negotiation in terms of what we mean by discretionary. I assume that when they are devolving these powers they will have to determine in legislation what discretionary means here. If at that point discretionary is defined in a way which gives the Scottish Government powers to do things universally, they can of course do that. If, however, it is, “We did a special case for the bedroom tax but now you can do that directly because you have housing benefit powers,” you do not need the special case any more and we are going back to the old definition of discretionary. That is a subject for negotiation, and subject to what is in the legislation implementing the Smith Commission—maybe in the next few weeks.

Professor McLaren: What is interesting to me about this conversation is what does the Smith agreement mean? When it was published, most of the public's perception was that benefits are reserved and some taxes have been devolved, whereas we are saying here that perhaps you can do a lot of things on the benefits and pensions side. Because of the wording, it could be interpreted either way and this could lead to various claims further down the line. The initial public perception may unravel and the actuality may be something different.

Q377 Chair: My understanding was that the intention had been to make sure that there was a universal level of provision. However, if the Scottish Government wished to top that up, they would have complete discretion to do so, but that then is a political choice and so on and so forth. Your people wanted to make sure, as I say, that the universality of the social contract across the whole of the UK was retained and therefore it was a minimum provision rather than a maximum, in the same way that, say, Glasgow council does things for pensioners above and beyond the state minimum. It is the same sort of power. You wanted to come in, John, in more general terms.

Professor McLaren: The conversation was dominated by all the things they could do that would make Scotland a very different place on the benefits and social contract side of things, whereas the reaction when Smith was set up and when it came out was that that should remain a UK-wide aspect of the cultural fabric of the UK.

Q378 Chair: To some extent I would have thought that is because people were approaching it with a particular mindset—that, no matter what Smith said, they were going to be negative. There was also insufficient ingenuity on display from those who should have been looking for ways in which they could make maximum use of the powers that were being offered. I found it quite disappointing that people did not seize on this and say, “This is actually better than we thought. This is immensely positive and would allow us a huge amount of flexibility.” The script was, “This is a disappointment and a grievance and we have been betrayed,” and so on. Therefore we ended up with a solution along the lines that we did.

Professor McLaren: I suppose there are a number of areas in the document. For example, paragraph 95(8) says: “The UK Parliament would continue to have a reserved power to levy an additional UK-wide tax if it felt it was in the UK national interest.” I guess that is a bit of a catch-all in terms of what you were thinking of.

Q379 Mr Reid: It might not be a bad thing.

Professor McLaren: Possibly, but is it in case you want to increase spending or reduce the borrowing so you would have a special tax that is about reducing the borrowing so Scotland would be paying its share of it? That would be quite contentious. I am not quite sure why things like that are in there. I can see a role for them, but what that role might turn out to be might be very different from what had been envisaged.

Q380 Chair: Surely that is the converse of the Scottish Parliament having the power to increase whatever welfare benefits it wishes, or not as the case might be. The intention was that we want a settlement. However, we want to leave a degree of flexibility for people to be

able to do other things for which they will be accountable and which are not necessarily identifiable at the moment.

Pamela asked about your view on how the Scottish Government might use the powers set up in 54. In terms of the general point, were you initially taking the view that this was more restrictive than perhaps we believed?

Professor McLaren: I had assumed from the political and press reaction at the time that it was largely seen to be that the UK Parliament would be making most of those decisions, and that Scotland had income tax and it could vary that, and that was the key change. It was a big change because there is a lot of money involved, but that was the key change. The discretion thing, because nobody was saying anything particularly different, sounded like bedroom tax and little things here and there—“You can have some of that”—rather than a significant increase of Universal Credit or pensions. As the discussion has gone on, that seems to be an option.

David Phillips: Or potential option, depending on what they actually meant by some of those slightly vague terms.

Q381 Chair: We will see what the Government propose in the legislation that comes forward. It will either clarify it or not, as the case might be. I want to move on to the question of implementation. What are the most challenging elements of the Smith agreement to implement?

David Phillips: To me, by far the most difficult thing is working out the block grant adjustments, and working out the issues around two things. One is the compensation for the knock-on effects we talked about earlier, and the need to limit them as much as possible because of the huge disagreements that take place. Secondly, there is this issue that tax changes in the rest of the UK should not affect the Scottish Government’s budgets and vice versa. That interacts with the block grant adjustments. It is a whole tricky area. We have been thinking about it in the IFS and we put a paper out towards the end of last month, which I think your secretariat has précised for you. There is a lot of work to be done there. It seems an area where there is scope for disagreement. As John McLaren said, they have not made an agreement on what to do with the two small taxes, which suggests that, if you are talking bigger taxes with bigger revenue implications, there is scope for potentially even more disagreement. We’ve got what is to be devolved. Now one of the biggest questions is how that interacts with the Barnett formula and the block grant in a way that is both fair and provides the right incentives and the right risks to both sides—the UK Government and the Scottish Government.

Q382 Pamela Nash: I was going to ask you about that later, but I presume the fact you are posing it as a question means that you do not have the answer. Professor McLaren, is there an obvious way round the predicament that Mr Phillips has just outlined? How do you ensure that there is not a benefit or a problem with the raising or lowering of taxes in the rest of the UK?

Professor McLaren: It goes back to the point we were making before. If there is good will involved you can probably reach a settlement. If there is a lot of money involved there is probably less likely to be good will involved and therefore there is going to be a bit of an

argument. People will use the best array of tools they have to get the best deal they can. There is no definitive system that can be put in place and that you could say is absolutely objective.

Q383 Pamela Nash: Do you think it would need to be negotiated each time that that problem came up? Is there any system that could be put in place that would fit all possibilities?

Professor McLaren: Yes, it is called Barnett. That is basically what Barnett's greatest attribute was. It removed all debate of this type. It was a simple formula: "That's what you get." Once you take away Barnett, even if you keep Barnett partly, it massively complicates the situation. It means that there is much more negotiation, tax by tax and year by year. There is always scope for argument within that.

I used to work in the Scottish civil service, and every year when the budget changed we would meet with Treasury officials and say, "Is that something we should get money for or not?" The one I remember most was that there was an enormous amount of money going in for a London underground extension. They said, "You are not getting any of that." We said, "I think we are; we have an underground in Scotland—Glasgow underground." We reached a deal. This stuff is serious.

Q384 Pamela Nash: We are talking about the Barnett formula which has been used for a long time now. We also have the issue in reverse now, if taxes are to be raised and changed in Scotland. That could affect our block grant from the UK. How would that work?

Professor McLaren: It will do. If the income tax in Scotland is raised—I am sorry, my bug is starting to overcome my thought processes. Do you want to say something, David?

David Phillips: I am happy to talk about this stuff. I have an answer, because I have thought about this quite a lot. Unfortunately, the answer is probably not the one you want to hear. It is impossible to deliver a system that is feasible and meets all the aims the Smith Commission wants the system to do. You cannot have a system which simultaneously deals with the revenue changes associated with policy changes and economic growth, and that has this "no detriment" principle, and at the same time means that any changes in taxes in England do not have knock-on effects for Scotland. It is a circle that cannot be squared, because different approaches deal with different problems, but as far as I can tell there is no one approach that deals with all the problems.

If I might bore you for a few minutes, I will explain one way that I think would work for adjusting the block grant and has lots of attractive features—you have already mentioned it briefly—but it does not solve all the problems. The way I talk about it in my paper, and it does have lots of attractive features, is that in year one you make an adjustment to the block grant by how much tax revenues are forecast to be raised in that year. In subsequent years, you index the block grant reduction you made to whatever happens to the revenues in the rest of the UK. If tax revenues from the devolved taxes go up by 10% in the rest of the UK, you increase the amount you have taken off the block grant by 10%.

The first good thing about that is that the Scottish Government have the right incentives. If it grows more quickly it gains; if it grows more slowly it loses. That gives the Scottish Government the incentive—a carrot and a stick—to look after the economy. It also works

quite nicely with some other things. Let us imagine that, rather than it being revenue growth because of economic growth in the rest of the country, it is because of changes in tax rates. Let us say that the UK Government put up income tax in the rest of the UK and then spend that money on things like health, education and other things in the rest of the UK. Under the Barnett formula, Scotland gets money when it spends more on health and education in the rest of the UK, so the Barnett formula would be saying, "Let's give more money to Scotland." But then Scotland would be getting more money without paying any higher taxes, which would seem unfair. But if you index the reduction you are making to the block grant to the tax revenues, you have put up tax rates, so tax revenues have gone up in the rest of the UK, and now you take more off the Scottish block grant. That balances out the additional money they would be getting through the Barnett formula. That means you have a system whereby, if you put up taxes in England and you spend more in England, Scotland gets money from Barnett but you take more from the block grant so that it all balances out. That is quite nice; that system works.

It does not work perfectly though, because taxes raise different amounts in different parts of the UK. The amount of income tax per person from Scotland is a little bit less than it is for the rest of the UK. This system does not deal with that completely perfectly. Professor David Bell, who hoped to be able to give evidence here today but could not make it, suggested another alternative. Sorry, it is getting very complicated now. Rather than increasing the block grant reduction in line with the percentage growth in tax revenues in the rest of the UK, you increase it in line with the per capita growth in the rest of the UK. That then all works out and deals with this problem completely. It all balances out and Scotland would not gain at all or lose at all from any changes in taxes in England. Under the percentage terms, it does not lose out or gain much, but there could be little effects on Scotland.

The problem with the per capita way of doing things, though, is that it deals less well with economic growth, because taxes often raise less in Scotland. Let us imagine there is 10% growth in revenues in both Scotland and England. In per person terms, that 10% in England is more in cash terms than it is in Scotland. Even if they were both growing at the same rate economically, Scotland would lose out from devolution under this per capita way of adjusting things and that does not seem fair.

Professor David Bell and I have looked at a number of the different ways in which you can do these block grant adjustments. None of them is perfect, but at least to me the one that looks the best, and has the best features, is to take off £10 billion in the block grant in the first year and then index that to what happens to the same tax revenues in the rest of the UK, and increase it by the same percentage terms. It is not perfect but I think that is probably the best that can be done. I have told the people at the Treasury that as well, so hopefully they will come on board.

Q385 Chair: I want to clarify one point. I can see the advantage of per capita because that allows for immigration flows. The population in England has been growing faster than the population in Scotland, with a greater degree of immigration and so on. Presumably, an overall tax-take in England would not necessarily be rising at the same level as in Scotland, all other things being equal, simply because the population is larger, but the per capita figure would be the same in those circumstances. Would you build that in?

David Phillips: There is a question about whether you would do that or not. That population growth is almost like forward-looking per capita, taking into account the population growth as well as the population levels. The example that David Bell looked at

in his blog post was not that example; he said, given the existing populations, do the per capita calculation. That would not deal with the issue that you just mentioned.

If you look at percentage growth overall, or percentage growth per capita, there is almost a political value judgment question rather than an economic one. At the moment, the Barnett formula does not take account of differential population growth on the spending side. In effect, the formula works at the moment on the basis that Scotland's population is growing at the same rate as England's population and therefore it needs the same increase in budget. Actually the Scottish population is not going up as quickly as England's and therefore it means that in per capita terms it gets a bigger increase in its budget.

You might think that an increase on the tax side as well, from an English perspective, can be seen as giving them a double dividend. They have gained on the spending side and they are not losing out on the revenue side. If the spending side is not taking account of differential population growth, maybe you do not want to do that on the revenue side as well, otherwise it could be seen from England and Wales that you have picked the measures that benefit Scotland. On spending, you do not take account of population growth, but on revenues you do. That could be seen as being unfair to the rest of the UK. On the other hand, that is how it works at the moment. The "no detriment" principle would seem to suggest doing it that way. There are real issues of fairness.

Professor McLaren: There is another complexity in the sense that there are not that many people who pay the higher rate of tax in Scotland versus the UK, mainly in London. The English tax base will probably grow quicker than the Scottish tax base if the recent past is anything to go by, because the wealthy people are on the English side. Rather than increase income tax as a whole, if you increased the higher rate of income tax, say to 60%, and it was then distributed across the UK, most of that would be coming from England and Scotland would be getting disproportionately more of it. If you want to be completely fair about these things, it could become a very complicated model to get right.

For a long time the English population has been growing faster than the Scottish population, so there are definite trends. If it is swings and roundabouts that is one thing, but if it is ongoing trends you would probably want to take that into account.

David Phillips: If you take it into account on the revenue side, you might want to adjust the Barnett formula so that it takes it into account on the spending side as well, which it does not do at the moment. Looking at the Smith proposals in isolation and not thinking about how they interact with the Barnett formula would be a mistake. It has to be seen to be fair on both the Barnett formula side and on the tax devolution side; otherwise, people in England, and particularly in Wales, I would imagine, will be complaining about it.

Professor McLaren: The Barnett formula has been adjusted a number of times over time for things that were built in to advantage Scotland from trends. The population was fixed in 1979 for a long time. Then it was updated occasionally and now it is updated yearly, which improved things.

David Phillips: We are getting quite technical now, I am afraid. It is always backward-looking on updates. It never adjusts for a forward-looking population change.

Professor McLaren: No, that's on two or three years.

Q386 Mark Menzies: Sticking to the issues of the Barnett formula, there has been a lot of discussion about getting the interaction between devolved taxes and the Barnett formula

right. In terms of its significance, how will the block grant post-implementation of Smith compare with the grant today in terms of size and proportion of the Scottish Government's budget?

David Phillips: There are two answers to that question. One relates to the Barnett formula and one relates to the block grant. Some people are under the misconception that the Barnett formula determines the size of the block grant. It does not do that at all. The Barnett formula is about the changes to the block grant that take place every year. In fact, with tax devolution, the Barnett formula, if it is done in the way that I suggest—and the Treasury seem to be thinking along the lines of making the adjustments that I am talking about—will carry on working in exactly the same way as it does now in the background. The Barnett formula itself is just as important as it is now, but you will also have these additional elements that affect the Scottish Government's budget, such as their own revenues. The Barnett formula carries on working and you have this additional element from the taxes.

Turning to the block grant, in terms of what proportion comes from the block grant and what proportion comes from revenues, I have crunched some numbers and it looks like half of the Scottish Government's overall budget will be from their own revenues—or just over half—and just under half will be coming from a block grant. In terms of their own revenues, it is important to bear in mind that it is not only the Smith Commission ones; they already have powers over business rates. To some extent you can think of council tax as being Scottish Government-controlled as well, because they ultimately set the rules by which local government do things, so it is about half.

Professor McLaren: One of the things about the Barnett formula and the thing that Smith came out with is that the figures should be exactly the same, and there should be no detriment to any side. Full fiscal autonomy gives you an easily understandable figure for why you have this amount of money to spend. A needs assessment would give you a rationale for why you get the money. The Barnett formula just gives you a contrived figure that has no rationale whatsoever. It is just reached for historical reasons. There is no defence of it other than it is what it is, but that is a very important political position because to move it up or down from there would create controversy. That sort of magical figure—I think it was in the vow as well that Scotland should not lose out—will change over time. If it continues with Barnett, it is a process which goes down the road, but there is no end point to it and there is no rationale for what it should be at any point in the future. That is perhaps a missed opportunity from the Smith Commission, or a wider debate about this. Surely there is a better way of deciding what that figure should be—an underlying figure that Scotland should get and then some incentives for Scotland to be able to grow its economy and its budget. This does not really give it. In some ways, it sets you back because it is as if we are fixed and we must stay at this position. I do not think that is very good.

Q387 Chair: We have another 97 questions that you have already covered in the discussions earlier on, you will be glad to hear. One of the points that we have not really picked up yet concerns the compensatory payments and so on. Smith said that there would have to be a mechanism to agree a shared evidence base. What could such a mechanism look like?

David Phillips: I have not had a chance to think about that yet, unfortunately. I do not know if John McLaren has.

Professor McLaren: I guess, first of all, you would want definitive figures about what tax has been collected and where it is from. From that you could maybe build a model, once you have a number of years of evidence, to say that if you change that it is likely to move this way. That could give you a more accurate idea of what compensations might be paid. There may be other evidence from other countries about what a good way to balance things up or adjust things might be. Typically, what happens in these instances is that I bring my evidence and you bring your evidence to maximise your case.

David Phillips: If I could add something, having had a chance to think about it in the last couple of seconds, Australia has an independent commission that deals with negotiations between the federal government and the state and territory governments on these kinds of issues. Maybe there is scope to look at what they do. As Professor McLaren said, in effect what will happen is that you will have these two different models—the Scottish Government model and the UK Government model—based on different assumptions. As we discussed earlier, getting the mechanical effects of these tax schemes is quite easy. It is the behavioural effects that are very difficult. You need some institution or organisation which can help with the negotiations or pass judgment on that. Some people have asked whether it could be the OBR that does that or some kind of intergovernmental version of the OBR.

Q388 Chair: Or ACAS possibly.

David Phillips: ACAS or the National Audit Office; I do not know. If some of these changes involve tens or even hundreds of millions of pounds of knock-on effects, that is quite a big financial plea for the Scottish Government side—quite a big financial hit or gain. There could be quite substantial scope for disagreement. You will need some kind of dispute resolution mechanism. That is to be decided. I don't have any great pearls of wisdom and I am not sure if anyone else has yet.

Professor McLaren: One of the difficulties with the system that is emerging in the UK is that it is so asymmetric. Wales is different and Northern Ireland is different from Scotland, on top of which England dominates them all anyway, and there is very little regional within that—whereas in the Australian and Canadian systems a needs assessment is usually an integral part, and they can do that because it is a properly federal system. We do not really have that. I suppose Spain is probably the most comparable, because Basque is almost entirely fiscally autonomous and the others have unique relationships. I am not sure how much Spain can tell us as to how to do a good job of these things.

Q389 Chair: The final point I want to try to clarify is this. Do you think that the Smith Commission proposals are inherently stable or inherently unstable? Would that depend upon whether or not there is good will on both sides?

David Phillips: I think it is too early to say. One of the things I am surprised about is that there has not been more noise from Scotland, now they have announced the devolution of corporation tax for Northern Ireland. I am not sure whether it is the calm before the storm of the election campaign. If that is indicative that there is acceptance for some time yet at least of the Smith agreement as opposed to the Smith proposals, and if that maintains itself, maybe they could last some time. It is the problem we talked about earlier. It has been very much presented as a political agreement as opposed to, “Here are some of the

fundamental economic principles that guided our decisions.” That really counts against it being more long-lasting, because, if it is fundamentally political, politics changes much more than the underlying economics. Maybe that will be something that comes to be regretted in time—the emphasis on the political side as opposed to the economics that can justify some of this.

I also think the block grant adjustment might not be correct. I spoke before Christmas about how that was done incorrectly for business rates. This is now much bigger than business rates. If it is done wrong, it will either hurt Scotland or hurt the rest of the UK. I imagine there will be much more discussion and dispute about that. It might not be the Smith proposals on tax that end up unwinding; it could be the whole fiscal architecture that ends up unwinding.

Professor McLaren: Obviously it will be partly driven by the politics of this in terms of who is dominant, but also by other economic events. For example, if we had the referendum again now, it would be a very different referendum because the price of oil is so low. All the predictions on oil revenues would be very low, so it would be fairly self-evident that Scotland would be considerably worse off, on a small snapshot of the start position, than as part of the UK. That was all happening while Smith was being debated, but it was barely in the debate. It was immediately taken out. They said, “We are not going to have that.” If you are asking for home rule or for fiscal autonomy, that is what you are going to get and you are going to be very badly off. At the minute, for the different parties that want independence, it is, “Well, we can’t say we don’t want that, but we would be in a very difficult position,” so there is no discussion of it.

If oil stays at a low price, I guess there is less chance that Smith would want to be revisited. If you got more powers, there is perhaps more potential for there to be a downside to the settlement. If oil goes back up and if the SNP continues to be the dominant party, not only of the Scottish Parliament but potentially down in the UK Parliament as well, you would quickly have quite strong demands for it to be reopened. What has happened recently is that other parties within the Scottish Parliament have tended to follow, to some extent, the SNP in a number of areas, including some of the things that are in Smith. That could move to a demand for more powers. Part of these external impacts could have a big influence on what happens.

Q390 Chair: Leaving aside the politics, if it is possible, I understand that there are obviously disputes about the bases and what the consequences are, but if there is good will can this system work, or are there issues in here that just make it inherently unstable and would make you say, “Look, this can’t work at all because of X, Y and Z”?

Professor McLaren: It is not inherently unstable and it can work even without good will. There will be more arguments but it could still work. One of the things we have to remember is that systems much more complicated than Barnett, and probably much more complicated than Smith, happen all over the world in different ways but you still get an agreement. It is never perfect. You can always pick up anomalies, as we have today, and kinks and things that are not ideal, but that is inevitable when you go away from the extreme simplicity of the Barnett formula. People in other countries deal with these things and they can be dealt with here. As I say, it will be easier if there is good will but it will still be possible even if there is not a huge amount of good will.

Q391 Chair: Do you agree with that?

David Phillips: Broadly, yes. The system is definitely imperfect. However, even if the reasoning has not been fully articulated in the document, thought has gone into what taxes should and should not be devolved. The broad proposals are sensible on the tax side and largely on the spending side, given the powers they have given them. It has the potential to be long-lasting. Where things could change is if politics intervenes or, as I said, if they get these block grant adjustments wrong and it is seen as being not unstable but just unfair. I think that is more the risk—that the Barnett formula comes under attack again or it seems unfair to Wales and England or things like that. The system itself is stable but the UK is a rapidly evolving Union now. Who knows where we are going to be in 10 years' time?

Q392 Chair: On that happy note can I ask you whether there is anything in this area of our discussions that you feel we have not touched on? Are there any points you would want to leave us with? I will also ask my colleagues if there are any other questions that they want to raise.

Professor McLaren: I have just a couple of things. I want to go back to the point I made earlier on, and it is in David's paper as well. It is this issue that any change in the UK income tax will have an impact on Scotland. That is not understood generally. If it is on the NHS, that is fine. If it is on borrowing or defence, that has the potential to be quite controversial. Scotland's budget would be cut or increased as a result of a decision that has been taken in the UK. There is going to be more on that as time goes on.

The other one is on the importance and potential impact of high income taxpayers in relation to Smith. High income taxpayers—is it the top 10% pay 50% of all income tax?

David Phillips: Across the UK as a whole the top 1% pays 25%.

Professor McLaren: And the top 5% or 10% pay 50%. Scotland has noticeably fewer than the UK as a whole. There could be a big incentive in Scotland to try to attract more rich people to Scotland. That would presumably mean reducing the higher rate of income tax, which is the reverse of what is typically talked about. If you increased the higher rate of income tax in Scotland, the high earners would move away and that would be a large loss of income tax. That is an area where you could get a big change happening, positive or negative, which has not been explored much so far.

David Phillips: I only have one comment to make. The Smith Commission spent a lot of time thinking about the principles of tax devolution and these issues about block grant adjustment, compensation, not benefiting and the “no detriment” principles. It was right that it thought about that. However, there was an event held recently in Edinburgh by a guy from the IMF who looked at 13 federal tax systems and devolution systems. He commented, when asked about these issues, “Wow, I have never seen any other country try to have a ‘no detriment’ principle.” Of course, when you devolve taxes you cannot have no detriment. It is going to have effects on people. That is an important thing to realise.

When you are devolving taxes you are devolving risks, and things are not going to be the same as they were before devolution. If they were, what would be the point of devolution in the first place? We should not put too much expectation on the Treasury or on the two Governments working out a solution that ticks all the boxes that you might want ticked.

Such a system does not operate elsewhere. I think it is impossible to square all the circles in the Smith Commission. A bit of realism about what is achievable on both sides—the UK Government side and the Scottish Government side—is important to maintain working relationships and go forward with this in good faith. That would be helpful.

Chair: On that optimistic note, thank you very much.