HOUSE OF LORDS

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Inquiry on

THE DEVOLUTION OF PUBLIC FINANCES IN THE UNITED KINGDOM

Evidence Session No. 2 *Heard in Public* *Questions 14 - 27*

WEDNESDAY 9 SEPTEMBER 2015

12.05 pm

Witnesses: Professor Ronald MacDonald, Professor Adam Tomkins

and Professor John McLaren

Members present

Lord Hollick (Chairman)
Lord Kerr of Kinlochard
Lord Lamont of Lerwick
Lord Turnbull

Examination of Witnesses

Professor Ronald MacDonald, Research Professor of Macroeconomics and International Finance, University of Glasgow, **Professor Adam Tomkins**, John Millar Chair of Public Law, University of Glasgow, and **Professor Jon McLaren**, Honorary Professor of Public Policy at the Business School, Glasgow University

Q14 The Chairman: I welcome you to the hearing and apologise for the late start, which was for reasons I think you know and understand. We have just come from a very interesting discussion with the Finance Committee of the Scottish Parliament with which we have a good rapport, and earlier this year we discussed these issues in some detail so we have a sense of the realpolitik of things. That was very helpful. If we can run through the questions which I know we have shared with you and then we can have a quick discussion of those. Given that there are three of you, in the interests of efficiency, if somebody has already said what you were going to say you do not need to repeat it. The first question is really around awareness of the proposals for devolution. Has there been enough transparency? Do people have a sufficiently good understanding of what is going on and what is happening?

Professor John McLaren: Clearly the answer is no. Given that the Barnett formula is considered by many to be extremely difficult to understand but in fact is one of the simplest things you could possibly use in terms of working out the funding system, it shows that this is a complex area that not just the public but even journalists can struggle to comprehend. If you take the Smith commission, when it reported it was taken as that was what it said, but there was not really much debate within Scotland, although they did go round a few meetings, and you did not really feel that people were engaging with it. When the report came out, it was not very well analysed. For example, the fact that Scotland would have the power to change any benefit level upwards is still not very well understood, as well as what the implications of income tax are and the no detriment principle and issues like that. Since

Smith, it has still not been discussed very much in any circles as far as I can see, and it is not very well understood across the political world, the media world and certainly among the population as a whole.

The Chairman: Is that a reluctance on the part of politicians to explain things or a lack of interest in the detail?

Professor John McLaren: I would be surprised if the average person would be particularly interested in this. Perhaps with the independence referendum it became a bit more interesting but I still do not think that most people are really going to engage. As soon as you use a word like “fiscal” people immediately say, “I don’t know what that means”, and they switch off. How would you improve that? It is difficult, but at least within political circles, within Parliament and within journalism you would hope that they would improve the quality of the debate and the interest in what would be a very important change. The same applies across the UK and in England, because there is increasing interest in moving to a more regional system in England. I do not know how well devo-Manc, for example, is understood.

Professor Ronald MacDonald: The only thing that I would add is that there is a common misperception that more devolution, and indeed fiscal autonomy, means more spending power and that there will be more to spend in Scotland. I think that that is a big misperception among the Scottish public. That is the thing that has not been got across; that actually, no, it does not mean that, it means that you are going to have to raise some taxes here to pay for the spending. That is the message that needs to be got across to the general public: a better understanding of fiscal autonomy, particularly full fiscal autonomy. I think that a lot of people, particularly supporters of the SNP, are banging the drum that this would allow us to do lots of things that we cannot do at the moment when in fact, if you look at the full fiscal autonomy proposal, it would not—but I do not think the general public understand it. Whether it is because of what John was saying, because they cannot grasp the technicalities, or whether they just do not understand the picture, I am not sure.

Professor Adam Tomkins: I am Adam Tomkins, John Millar Professor of Public Law at the University of Glasgow. I was a member of the Smith commission and after the election I was appointed by the Secretary of State for Scotland to be constitutional adviser to the Scotland Office. I am also a prospective parliamentary candidate for the Scottish Conservatives at the Holyrood election. However, I do not appear before you today with any of those hats on. I am not speaking on behalf of the Government or the party or the University of Glasgow or anybody else, just myself; I want to make that clear for the record. I agree with what has been said so far and to it I would add that I think the Scots have fallen out of love with the idea of devolution. If you compare now the arguments about devolution with the arguments last year about independence, there is a very great contrast. If you compare also the arguments now about devolution with the arguments 20 years ago about devolution and the Scottish Constitutional Convention, there is no passion any more for the idea of devolution because it has become a technocratic exercise. Even the word “devolution” itself is a word that we do not use outside this context. I would much rather be talking about home rule, not because I am a Gladstonian but because it is a more emotive phrase and it is more likely to capture something about what it is that Scots crave. It seems to me that what Scots crave is exactly that: a sense of home rule without leaving the United Kingdom and becoming a new independent state. Those of us who are on the unionist side of the argument have to find a way of allowing something of the union and allowing something of the devolutionary idea of a union to re-enter Scots’ hearts as well as their minds, and we have not even really started that, to be honest. I think that is the problem.

I agree with what John said that arguments about the Scotland Act 2012 and arguments about the current Scotland Bill, which is in the Commons and will come to the House of Lords shortly, are arguments which are very technical about which taxes to devolve and when and why and what rates of tax should be set here and there, which are not the sorts of arguments that are going to, as they say, set the heather alight. That is the reality of where we are. We have to deliver Smith. We have to pass the Scotland Bill. We have to get the fiscal framework right and then, once we have done that, I think we will be able to draw something of a line, although that is a dangerous phrase. Where I would like to get to is to reverse Ron Davies’s famous aphorism that devolution is a process and not an event. I would like to get to the point where we can say, at least in Scotland—we will not be able to say it in Wales or perhaps Northern Ireland for a while yet—that this is Scottish devolution; this is home rule for Scotland within the United Kingdom. It has now been delivered; now let’s get on and use it and through the using of it begin to understand its strengths as well as its limitations.

Q15 Lord Turnbull: Is not one of the reasons that politicians do not talk about this that they understand the Barnett formula extremely well and they know that it is pretty generous compared with Wales? The two countries had similar GDP per head four years ago and they have diverged but the funding formulae have not recognised that at all, and they just want to hang on to it, and the best way to hang on to it is just to refuse to discuss it. They just say, “Keep the Barnett formula” and they do not distinguish between a mechanism for updating, which you can defend as quite a good mechanism for updating, with the baseline from which it starts. We are trying to create a new federal settlement amongst the nations and it would be very good if that started with no hard feelings on either side, with both sides recognising that it started off fair. In England that is not accepted at all, in Wales that is not accepted at all and particularly in the north of England they think that it is unfair, and yet they are dealing with a group of people who do not want to discuss it.

Professor Adam Tomkins: I am not an economist, I am a constitutional lawyer, and constitutional reform in the United Kingdom works when it is consensual. At the moment it is very difficult to find any degree of consensus around what we might call the territorial constitution or the future of the union. It is not in the Scottish Government’s interests to make devolution work. It is in the Scottish Government’s interests for devolution to be understood and to be seen in Scotland as inadequate to meet Scotland’s needs so that support for independence goes up. We all know that, despite last year’s defeat, the Scottish National Party has not given up its pursuit of constitutional independence for Scotland. It is going to be very difficult while the SNP is forming a majority Government in Holyrood to have that degree of consensus between the two Governments of the UK and Scotland. There is also now, unfortunately, clear and manifest distrust between the principal unionist parties, the Conservative Party and the Labour Party, over the direction of the territorial constitution. There is no agreement that I can see between the Labour Front Bench, whoever they are this week, and the Treasury Front Bench on English votes for English laws. There is concern in Cardiff about the way in which the St David’s Day process is being delivered through a Wales Bill that we have not yet had sight of. I suppose that this is not much more than a wistful lament that “one would not start from here”. Something that we absolutely need is some degree of stitching a coalition together that is seen as, if not all-party, at least cross-party—that is, designed to revisit and to revise the United Kingdom’s territorial constitution. It might be that in the atmosphere of the House of Lords, which is much less partisan than the lower House, we can begin that quest. I hope so, because we need it.

Q16 Lord Lamont of Lerwick: We have heard various views about the Barnett formula. Some people have advocated a needs-based system and other models have been put forward. I notice that the Smith commission, of which you were a member, said: "Once a revised funding framework has been agreed, its effective operation should not require frequent ongoing negotiation, albeit it should be subject to periodic review". But the Command Paper made a slightly different observation that the funding model should be mechanical rather than requiring regular negotiations. I know that you have expressed an opinion suggesting that there should be a degree of adaptability and an element of negotiation. It seems to me that it is very, very difficult to find a mechanical formula. To have a system in which there are reviews, followed by reviews, followed by reviews, arguing over what has happened and over where we are is just a recipe, to my mind, for continuing antagonism and tension. However, it is very difficult to know what mechanical formula there could be.

Professor John McLaren: The Barnett formula is a very mechanical formula but even within the Barnett formula—I used to be a civil servant in both the Treasury and the Scottish Office—there used to be negotiation between officials, and I guess that eventually it would go to Ministers.

Lord Lamont of Lerwick: You "guess" that it went to the Ministers?

Professor John McLaren: Usually we would manage to agree among ourselves.

Lord Lamont of Lerwick: That confirms what I always thought.

Professor John McLaren: Yes, Minister. For example, they would say, "There has been a huge amount of investment in the London Underground but there are no consequentials in Scotland because you do not have any underground", at which point we would say, "Yes, we do, there's a Glasgow underground", at which point they would say, "You're joking, aren't you?". Well, it might not be very big but it is still an underground.

Lord Lamont of Lerwick: Then you could negotiate about trams as well.

Professor John McLaren: So then you would have to negotiate through that. When the Barnett formula was set up, it was amended to adjust for population because the English population was rising so much quicker than the Scottish population, and there have been one-off things such as what happens when water becomes private but stays public in Scotland. The IFS recently pointed out the idiosyncrasy with business rates. There would always be a need to change things due to changing circumstances, usually politically led changing circumstances. That is what I meant when I said that you could not just set it once and leave it there.

To go back to the point you made about whether it would be better to start with a needs assessment, I cannot see how you can move from Barnett to something completely different. You cannot do it in terms of the way education, health or local government money is split. All of those are unfair at the minute and not based on needs. The Welsh have tried to do something recently and put a transformation period in and it just has not happened, because the losers scream blue murder and the winners usually do not know who they are. Nobody is going to accept the political pain, especially if you are going to lose £1 or £2 billion, which is what has been put forward for Scotland. So we need to start from where we are and then see if we still want a degree of convergence—which is what Barnett was supposed to do in the first place, but does not largely due to population changes—and how that can best be brought about. The way that income tax is set up at the minute will probably bring about some convergence because income tax in England is likely to grow more quickly than in Scotland, but that could be adjusted.

Lord Lamont of Lerwick: Income tax could be changed.

Professor John McLaren: Yes, because of the growing population, the demographics and more people in the higher band in England than in Scotland, it is likely to grow faster in England, which would mean that Scotland would lose out because of the adjustment process.

Lord Lamont of Lerwick: My question was not about Barnett but about mechanics and the principle of "mechanimity", if there is such a word.

Professor Ronald MacDonald: In the Australian system it is revisited every five years, which seems to me not too bad a way of dealing with it. You do not want to get into the situation, which is perhaps what you are referring to, where you are looking at it every year. You want a period where you revisit it, especially if there is some indexation of the block grant and you are seeing a diminution of the block grant as your tax revenue increases. I think we need a block grant. In any system such as this, which is short of full fiscal autonomy, you have to have a block grant. I think, as we have noted, that for reasons of equity we want to move away from Barnett. I think John is right that if we were to introduce a new needs assessment at the moment it would show that Scotland was being very generously provided for under Barnett: maybe 120 relative to 110 would be the correct figure, so there is a big political economy issue there if you say, “We want to take that money away from you guys” at the starting point. I think that would be difficult and I agree with what John is proposing, that you would have some adjustment mechanism going forward. But I think that that would have to be reviewed in some fashion, perhaps by an independent body.

Lord Turnbull: With convergence, unless you have a needs assessment you do not know what it is you are trying to converge on and you do not know how far you are off track. Therefore, going forward, one of them is slightly marking time and the other one catches up. A needs-based assessment is needed to guide you from review to review on what direction you want to move in, and the gap that is perceived by people in Wales and Northern Ireland is seen as material.

Q17 Lord Kerr of Kinlochard: I would like to challenge the wisdom that Barnett has favoured the Scots. I think that that entirely depends on what you think is the capital cost of providing the services that ought to be provided at a particular level across the United Kingdom, in each of the United Kingdom. It is quite plausible that in the Highlands and Islands it is much more expensive to provide health and education, partly due to the cost of transport and partly because of population geography. We hear that the Smith commission did not discuss it and took it as a given that the Barnett formula was going to survive. Okay, the realpolitik says that it is going to survive; no party is saying that it should go. But during these five years when we are stuck with Barnett, surely we should be devising some better long-term system?

Professor Adam Tomkins: I think that it is fair to say that the Smith commission did take it as a given that Barnett would survive because it was in the Vow, and the Smith Commission was meeting and working in the shadow of the Vow, if I can put it like that, which has become a sort of 21st century Caledonian “Magna McCarta”. That is why you find in paragraph 95.1 the Smith commission saying that the block grant from the UK Government to Scotland will continue to be determined by the operation of the Barnett formula. Of course the size and therefore the importance of the block grant diminishes the more we go down the route of fiscal devolution. Again, the hope is that some of the politics and some of the heat and some of the noise around—

Lord Lamont of Lerwick: Can you give an estimate of how much it will decline proportionately as a result of devolution?

Professor Adam Tomkins: I cannot, because being a lawyer I am not very good with numbers, but I am sure that others around the table can. I would approach this by saying that there are some grand constitutional principles, or you might call them something more mundane than that, that one can bring to bear on the operation of the Barnett formula. Is it fair? Is it manifestly seen to be fair? Is it transparent? It is not transparent. John says that it is easy to understand but from the outside it is also fabulously opaque: it is a black box. There is very little effective parliamentary scrutiny either in the United Kingdom Parliament or in Holyrood of the operation of any aspect of the fiscal framework. There is a lack of effective parliamentary oversight. There is also a trend for certain key economic decisions to be made by independent arm's-length bodies that are accountable indirectly to Parliament and to Ministers but differentiated from both Parliament and Ministers. Perhaps there is a case for doing something like the Australians have with their Grants Commission, or something like we have with our OBR, which would take us out of the domain of intergovernmental negotiations between the Chancellor and the Cabinet Secretary for Finance. I am not necessarily signed up to that; I would like to hear the arguments for and against.

Lord Lamont of Lerwick: It is rather different to take away a forecast from a department compared to taking away the power to spend money.

Professor Adam Tomkins: You might be right, but if one thinks about this through the lens of fairness, transparency, oversight and independence, it seems to me that is a useful framework of analysis.

Professor John McLaren: I have done some work on needs assessments, again as a civil servant. The idea that they are objective is wrong; they are very subjective. Everybody will put something different forward. We did it back in 1992 when we were fighting the Treasury. For example, we would say that life expectancy is shorter in Scotland, therefore we should get more money for health, and they would say that life expectancy is shorter in Scotland, therefore we do not spend so much time in hospitals, therefore we need less money. You do not need a service because you are dying younger. That is a flippant example but that did come up. There are all sorts of questions about how you weight things. These are pretty subjective elements. Canada and Australia are so huge, and the states within them are so enormous, that they are very different things. We are a small country. Even if you look at Wales, for example, the north of Wales is right beside Liverpool, the south of Wales is right beside Bristol, and the middle is near various parts of the West Midlands, so what is the need of Wales that can be shared with the West Midlands and what is it on its own? To go back to your point about the needs of Scotland, the geographical need from the work that I have seen is about 3% to 5%. It is quite small because of the small population, even with the Highlands and Islands. I think that there is another argument that some people would put forward about the revenue side being from the North Sea, but that is a whole different kettle of fish.

Q18 The Chairman: On the Smith commission, did you see modelling and worked examples of the formula and how the formula would be indexed and how it would work when it was discussed? Is that something that you spent a considerable amount of time on?

Professor Adam Tomkins: No, it was not.

The Chairman: So this was waved through?

Professor Adam Tomkins: What was waved through?

The Chairman: The Barnett formula.

Professor Adam Tomkins: A working assumption, as Lord Kerr put it, of the Smith commission was that we were there to try and deliver on what had been said in the Vow. The one thing that was said in the Vow that had not been said by the parties previously in their commitments was a commitment to maintain the Barnett formula. The working assumption throughout, I think I am right in saying, was that Barnett would stay and that we would have to devise a suite of new powers and responsibilities for the Scottish Parliament that would be compatible with the ongoing operation of the Barnett formula.

Lord Kerr of Kinlochard: I agree that deriving objective criteria is a very subjective business but I think one has to try. It seems to me that what Professor Tomkins wanted to achieve, —is a result, a settlement and the end of devolution as a process— will never be achieved while the block grant is based on Barnett because nobody understands Barnett. Not even all the academic strength across this table could teach Barnett to a school class and try to explain the basis of the block grant system in this country; it is impossible. I think that we should be using this Parliament to devise a long-term system. It may be that some do not want to see a long-term system because they like annual controversy because it helps their political aim, but it seems to me that the House of Lords of the United Kingdom should be trying to propose something which would achieve what Professor Tomkins is talking about: some sort of cemented deal.

Professor John McLaren: It is important to distinguish between the block grant system, which is extremely complicated and difficult to understand, and the Barnett formula, which is extremely simple and which is basically just that Scotland gets its population share of any increase in English departments that are comparable to Scotland. It is a one-liner. But what you put that simple amount into is very complicated. If you try to understand it historically, it becomes this very different political thing. That is path-dependent on how we have got here, but the point is how you get off that path on to another path. If you try to adjust it in one year, that might be quite lot of money and that would be difficult; but if you try to adjust it in 10 years, it is 10 years of griping versus one year of doing it all in one. Or you accept what the position is now, which might not be fair but you accept it, and then move on.

At the minute we are just looking at Scotland, Wales and Northern Ireland. England is interesting, because it would be fairer overall if you did this needs assessment for the whole of the UK, but then it becomes very complicated to work out whether the data are available and then what is fair within the UK. For example, again you have, say, Lancashire in the north-west on the borders, and where the hospitals should be, and does the south-east not have many hospitals because they use the London hospitals?—all sorts of issues like that. I agree that it is some effort to move in that direction but having at least some background information to which people could refer would be good. I am less certain about how much it would influence the realpolitik of what emerges.

Q19 The Chairman: Against that background, how should the calculation of a block grant affect the devolved powers of taxation?

Professor John McLaren: What do you mean? I am not quite clear.

The Chairman: You have got to calculate the block grant each year and then the taxes that have been devolved are going to move up and down, mainly down, so how do you then reflect that in the calculation?

Lord Lamont of Lerwick: That is the no-detriment principle.

The Chairman: The second stage of no detriment. How do you deal with that over time?

Professor John McLaren: Jim Gallagher said in his paper produced a couple of days ago that it had been settled for the previous Scotland Bill. I am not aware of that. You look at how UK income tax has grown and you adjust that for the Scottish block and then Scotland has to raise its own tax to fill in that gap, more or less; we will give you more or less money. As I said before, you do not necessarily have to pick growth in income tax. If you do pick that, is it income tax growth per head of population, do you adjust for population and do you adjust for demographics? There are elements like that. You could make it a more complicated adjustment. If it starts to look like one country is losing out consistently, which is likely to be Scotland, again a point of grievance could easily arise.

Lord Lamont of Lerwick: Slightly skipping ahead, how does no detriment apply to tax competition?

Professor Ronald MacDonald: Is this getting at the idea that if you are successful in raising or lowering taxes—presumably lowering taxes—that stimulates growth, then you have to adjust the block grant? Is that what lies behind your question?

Lord Lamont of Lerwick: At our previous session one of the members was really rather against tax competition; he called it unhelpful or anti-social tax competition. I think it depends from which side you are looking at it. It just occurred to me that when a country took an initial step to cut its corporation tax in order to attract inward investment, is someone going to say, "The no-detriment principle applies here and we ought to be compensated because this has a direct knock-on effect on us initially"?

Professor Ronald MacDonald: There are a couple of reactions to that. One is that in our submission to the Smith commission, my co-author, Paul Hallwood, and I had something we called the "Holtham interlude". There should be a period over which you can adjust things but you do it quite gradually, so if you are successful in cutting corporation tax and that boosts your growth, there should be an adjustment but it does not all come in the current period.

Lord Lamont of Lerwick: But it would be rather odd if we had to compensate other people because they had pursued the wrong rate of corporation tax and not maximised revenue.

Professor Ronald MacDonald: Indeed. That is why if you look at the fiscal federalist literature you do not see that concept. It is not there. It is a political concept. Indeed, in the more recent fiscal devolution literature it is all about tax competition controlling the size of the state, and so tax competition is seen as good per se. I am not necessarily saying that I agree with that but that is where the economics of this is taking us essentially.

Q20 The Chairman: Gerry Holtham said that the no-detriment proposal is impractical and cannot be made operational unless it is dictatorial and that a different range is necessary. Do you agree with that?

Professor Ronald MacDonald: I think I would. Probably what he is getting at there is his idea of indexing. This is like the second stage of no detriment. I think I would broadly agree with that, yes.

Lord Turnbull: The example that was given was a very simplified one where the UK Government cut income tax and says that they are funding this by cutting a service, and then you get a different effect on Scotland where the service it cuts is health or defence. However, since you did not know what was actually funded by income tax, how did you know that was why health got slowed down rather than defence?

Professor John McLaren: This is something that I spend quite a lot of time thinking about. It is quite complicated. It does not matter what you change. If the UK changes its income tax rate, it does not matter where it spends it; Scotland's block would be adjusted. If the rest of the UK used extra revenues and spent it on devolved services, Scotland's block grant would rise—but the Scots are not paying for it by more tax so it would have to be adjusted down. Equally, if it was spent on defence, Scots are getting that benefit in defence as a reserved asset but are not paying for it. So it does not matter what it is spent on, there would have to be an adjustment, and the same the other way round.

Lord Turnbull: But you would never be able to disentangle cause and effect.

Professor John McLaren: I think it is easier because you do not have to. In each case there is a benefit to Scotland and therefore Scotland has to pay for it, whether it is defence or health. You would get a political argument if it was going on defence and then seen to be spent on nuclear weapons or something like that. That might not be very much liked. Otherwise it is a free lunch. I went through this with Treasury officials and they said that it was correct. I think it is slightly different from what Jim Gallagher says in his paper but I am pretty sure that it is correct. Again, it took me quite a lot of time to fully work it out; it is counterintuitive and it has not been debated at all in public. It could lead to people thinking, "Really? We have to give Scotland more money when we cut taxes?"

Professor Ronald MacDonald: Could we not get away from this form of no detriment by moving away from Barnett, because a lot of what we are saying here is to do with Barnett consequentials? If you have a different block grant, presumably these kinds of no-detriment issues would not arise? Others may but not that particular one.

Lord Turnbull: It would seem from our earlier meeting they have largely given up on this second-tier no-detriment principle. They have realised how difficult it is and they are just relying on the fact that the system in a much broader sense will have to be maintained, possibly by this Australian-type body which is starting to diverge from the starting point. Going through measure by measure, if you cut the income tax rate it might actually go up. You cannot even get the first stage of this calculation right. The no-detriment principle is probably dead.

Professor John McLaren: I think that no detriment was probably applying more to benefits in the way that they saw it, in that if you adjust something and it has a knock-on effect on benefits then you have to pay for it yourself. But on taxes it did not really apply. For example, Northern Ireland gets corporation tax. If it gets more business and companies in and Manchester says, "They were going to come here; they only went there because they have lower corporation tax", the reply is, "Sorry, that's the way the game goes". Or if you reduced the higher band of income tax in Scotland and people moved from London to Edinburgh, that is what it is supposed to do. So I do not think that it is supposed to be adjusted for that sort of element.

Lord Turnbull: Indexation was tax to tax, was it not?

Professor John McLaren: There is regional adjustment, and again it is a moot point whether it is a good year or a bad year for you. Then there is the indexation which is adjusted to a certain thing. But once you have behavioural impacts if you have adjusted taxes, I think that is fair play.

The Chairman: So how would this work? If the second part of the no-detriment principle is raised to a principle and there is no mechanism and then you have got the existing Barnett formula, you are then making adjustments on what basis?

Professor John McLaren: If I am reading it right—because it can be difficult to follow—on the basis that if income tax has grown in the rest of the UK, that is assumed to be what would have happened in Scotland, but if Scotland is outgrowing the UK, then it gets its extra money. That is my understanding.

Lord Kerr of Kinlochard: I am assuming that is on a per capita basis.

Professor John McLaren: I would say on a per capita basis. The reason I say that is because if Scotland had been given powers over immigration policy then that is okay because Scotland can say, "We can't attract more people in, therefore we suffer because we have the wrong policies". But if they cannot change those policies and more people are coming into England than Scotland, I do not think that is a level playing field and therefore I would adjust it in per capita terms.

The Chairman: It would be adjusted also for the benefits analysis that you gave just now. To the extent that benefits were changed, or not changed and they were changed in the rest of the UK, there would be an adjustment in line with that.

Professor John McLaren: Yes. There is also a complication if you are changing tax rates and starting points and things like that. It is okay if you change one and try and estimate what that impact would be and see no detriment, but 20 years down the line and there have been 10 changes in income tax levels and rates are higher and lower, can you really make a good estimate of that? I guess you just make the best estimate you can as time goes on, but again it opens up room for mischief.

Q21 The Chairman: Did the Smith commission envisage a five-year review? How did you think this would develop over time and reviewing it over time?

Professor Adam Tomkins: I do not know if I recall whether there was a collective view about that. For myself—I am not speaking on behalf of the Smith commission as a whole—I think that we were all conscious that there were loose ends left in the Smith commission agreement that were deliberately left there, or inevitably left there perhaps I should say, because of the constraints of time under which we were working. The Smith commission reported only seven weeks after it was established. That timetable was not set by anybody in the Smith commission. The core work that we had to undertake around the Smith commission table was to agree a package of further powers for the Scottish Parliament. Our terms of reference were actually quite limited. We were not able to talk about devolution within Scotland, for example, even though some of us wanted to. We were only able to talk about devolution to Scotland. Almost all the time in the Smith commission was spent on working out what those currently reserved powers were that could be devolved to the Scottish Parliament consistent with Scotland remaining in the union.

For example, when we were thinking about universal credit, clearly there is a relationship between the design and delivery of that and a single United Kingdom employment market. A single United Kingdom employment market was something that certainly Annabel Goldie and I wanted to preserve because that is what we thought 2 million Scots had just voted for. When you are thinking about the relationship between the devolution of particular welfare powers, such as social security powers or social security entitlements, and this idea of union that we have, which is the pooling and sharing of risk and resources and the single employment market, what we spent most of our time trying to scrutinise and think anxiously about was the extent to which you could go further down the devolution path without running the risk that you were just tearing up the fabric of the union itself. If we had had another six months, it might be that we would have been able to spend much more time thinking about the kinds of questions that you are now having to think about, and others are having to think about, in terms of negotiating the fiscal framework. But the fact was that we only had seven weeks or whatever it was, and it is pretty remarkable that we got as far as we did.

Q22 Lord Lamont of Lerwick: Can I ask a question about an issue that was also raised in the Smith commission but I do not think we have touched on so far? We have discussed variously the responsibility of the Scottish Government and their borrowing and what dangers there are in that, but one small answer to that is the Scottish Fiscal Commission. Do you think the right model is being followed with the Fiscal Commission? There seems to have been some doubt as to whether its own forecasts are going to be independent forecasts or whether it is just validating without any real resources of its own what the Scottish Government say that they expect about revenues and expenditure?

Professor Ronald MacDonald: That is the danger. There is a question as to how independent that body is because two of the three members were former members of the Council of Economic Advisers, which one assumes is a very partisan body. There are questions that you alluded to about how well resourced it is. I do not think that it is well resourced to make independent forecasts and certainly to collect separate data, so I think that there are real issues with that body. There is no doubt we need a body like that.

Lord Lamont of Lerwick: Because that would greatly increase the freedom of the Scottish Government to pursue a policy that they wanted to pursue, whether it was responsible or not?

Professor Ronald MacDonald: Indeed, yes. That is an issue that has to be thought through. I gave evidence earlier in the year to the Finance Committee of the Scottish Parliament and made that very point.

The Chairman: They need some sort of OBR-type body?

Professor Ronald MacDonald: Exactly. Perhaps we may tap into the OBR as well, but that perhaps would not be—

Lord Lamont of Lerwick: I think that John Swinney tried to argue that the OBR took the figures from the Treasury, but that was strongly denied by the OBR.

Professor John McLaren: The OBR and the Treasury inevitably work closely together, but I know some of the characters in the OBR and they are pretty independent-minded. One of the issues is what Scottish model you are working from, because there is not a full model of the Scottish economy and if that does not exist it is difficult for anybody to be precise about what is going to be happening. That needs to be built up. The finance department in the Scottish Government as a whole needs to be beefed up if it is going to take on more Treasury-like responsibilities. That is concentrating on the good, developed example of Scotland, whereas Wales, Northern Ireland and internally in England are way behind in terms of the quality of the data and having a fiscal commission or having any sort of model, so I think there are some big challenges there.

Q23 The Chairman: There is a small list of taxes that are being devolved and there is a large list of taxes that are not being devolved. If you are seeking to run a balanced tax policy across the economy, does that not present considerable problems? Are there taxes for instance that you think should be devolved?

Professor Ronald MacDonald: Certainly in my own work I have always left open the ability for corporation tax to be devolved because it is devolved in other systems. I am not necessarily convinced that it would make a huge difference but it has to be borne in mind that the SNP has always argued that is the lever it wants to control. It has never, really, in my experience, mentioned income tax. It proposed putting it up. Many years ago John Swinney proposed to put it up by a penny and it has not done that again because the SNP lost a lot of votes as a result of that. Corporation tax is the lever it always mentions. Certainly I would have preferred a better balance between the taxes that were devolved, because then you could think about them having actual trade-offs: "Well, we cut corporation tax; what do we do, cut spending or increase income tax to pay for that?"

Professor Adam Tomkins: I talked earlier about consensus. This is where there is a greater degree of consensus than there is on some of the other aspects of the territorial constitution. This is also where the Smith commission was starting with a rare advantage, because all three of the parties that campaigned for a no vote had prepared their own proposals for devolution during the course of the independence referendum campaign. The IPPR had published a couple of very interesting and authoritative reports on it, authored by

Alan Trench, who has already given evidence to your Committee. The devo-max group, with Reform Scotland and Lord Purvis—Jeremy Purvis—have also done a lot of work. We were not starting from a blank piece of paper when it came to fiscal devolution because all of these sources—the party commissions, the think tanks and others—had all focused on tax devolution more than any other aspect of devolution. Why? Because the core problem with Scottish devolution, and a core reason why Scottish devolution has not done what George Robertson claimed it would do, which is kill nationalism stone dead, is because we have created here a Parliament that is responsible for spending £35 billion of somebody else's money without being responsible for having to go to those people and say, "This is the money we want to take from you and this is what we will do with it". Closing that fiscal gap was the core political imperative so far as I could see, which is why so much of the focus has been on fiscal devolution. There are limits with what we can do in terms of fiscal devolution while we are a member state of the European Union. The tax that is devolved in the United States or in Canada and I think in Australia, which you cannot do here, is VAT. It is a significant amount of revenue.

Lord Kerr of Kinlochard: Sorry, why do we not do it here?

Professor Adam Tomkins: Because it is contrary to European Union law to have more than one rate of VAT in any member state. While the United Kingdom continues to be a member state of the European Union we cannot have sales tax devolution.

Lord Lamont of Lerwick: The Greek islands managed to have it.

Professor Adam Tomkins: Maybe that is not an altogether happy precedent.

Lord Kerr of Kinlochard: If that is a serious problem, it could be corrected very easily in Brussels. That is not fundamental to the VAT structure. That was not a problem that was addressed when the original VAT directive was passed.

Lord Turnbull: What it means, John, is that—

Lord Kerr of Kinlochard: Because the VAT structure in Brussels is written in terms of minima, it would be quite easy in fact to accommodate differential rates of VAT. If there is something in the law which says you cannot—

Professor Adam Tomkins: I think you start running up against state aid questions as well.

Lord Kerr of Kinlochard: You might.

Q24 Lord Turnbull: The thing I was struck by in the earlier meeting, and what caused the biggest disagreement, was the phrase in the UK Government Command Paper, "The fiscal framework must require Scotland to contribute proportionately to fiscal consolidation at the pace set out by the UK Government". In other words, the UK Government are trying to get their debt down from 5% of GDP to 0% in five years; Scotland has to follow the same path. I think they really think, "Why can't we say we are happy with 5%? We will borrow the money. We will pay the debt on that money". John Swinney has set a limit on how much debt repayments can be. We have no basis for relating their aspirations on fiscal policy, on borrowing, to the UK. On the other hand, they say that they favour a balanced budget. As long as they follow that, they would actually be following the UK as a whole, but they do not like the idea that the Government say, "We have got to accelerate the process of getting the debt down or we go off track again" and then there is an argument about how quickly you get back on track. They want to say, "No, we don't want to follow that; we want a different path".

Lord Lamont of Lerwick: But it could be within a disciplined trajectory while the UK was still reducing its deficit, surely?

Lord Turnbull: If you listen to Scottish politicians, it is almost as though they want an end to austerity: ie "We do not want to be locked into austerity".

Professor Adam Tomkins: This is of course driven by politics. The current Scottish Government want to be able to say to the people of Scotland that the nation of Scotland and the nation of England are two different nations moving in two different directions. The economy of Scotland and the economy of England are two different economies moving in two different directions. This is all about their pursuit of independence. The SNP is a difficult political party to understand for anybody who has ever experienced British politics. Most British politics is about strategy. SNP politicians are not interested in strategy at all. They are interested in a destination. They are destination politicians. Their destination is independence and everything else is tactics and how you manoeuvre your way towards that goal. This is just a little bit of tactical manoeuvring by the SNP.

Professor John McLaren: Even if both agree a debt level and an annual borrowing limit, it is possible to agree that, but agree it at different paces. You could get some fudge to say that within an economic cycle we will both do the same thing; I would not be surprised if something like that happened. In terms of trying to address these issues, what could be contentious moving forward, if it is kept in the hands of the politicians, is that every time a new Government are brought in for the UK as a whole, they might change what their targets are. They have already changed enormously quite a few times in the last 10 years; even in the last three or four years they have changed quite a lot. It seems to me that Scotland would probably have to go along with what the rest of the UK has done. It may be given a little bit of leeway to catch up more slowly, but I see that as a pretty lopsided arrangement and I just do not think that the UK Government would pay much attention to what the Scottish Government want. I may be wrong but that is the way it currently looks to me. That could lead to tensions. How do you decide how much extra leeway Scotland should have?

Q25 The Chairman: This point about fiscal consolidation is very interesting. The Chancellor appeared before us yesterday. He acknowledged that between March this year and July he actually changed the year in which he was looking for a surplus from 2018-19 to 2019-20. He also made the point that the bargain that he was offering to the corporate sector was, "We will give you a much lower corporation tax but you will have to pay sufficient to your workers to ensure that the state does not have to pay in-work benefits". That was bluntly the formula that he gave. That is a political judgment, and we could argue the toss about it. But under these arrangements it would follow that that would be imposed upon Scotland, so the room to manoeuvre seems to be relatively narrow.

Professor John McLaren: One way of getting around that would be to give some of these targets and ranges of powers to the OBR, as the Bank of England was given extra powers to set these things, but I do not see politicians wanting to give up that degree of control. Can I make one point going back to the discussion on corporation tax, about which not much is made? I think that there is quite a big issue in terms of corporation tax from North Sea oil revenues as a whole. The big difference between Scotland and the rest of the UK in terms of tax is the North Sea. I understand why it was taken out by the Smith commission and why it is not a very good tax to devolve because it is so up and down, but at the same time it is the key difference between the two tax structures. Anywhere else in the world, whether it is Alberta or parts of Norway, you get something by having that in your backyard. In the past, the arrangement has been that you get more through Barnett and that is funded by the North Sea. That is the rough arrangement. Nobody acknowledges it but that is what happens and we are reasonably happy. But as the North Sea moves on or if we move to a different system, we have to address that more fundamentally and say what it is that Scotland gets from the North Sea, or in future what it is that the north-west of England gets from shale oil.

I understand why this was passed over in the Smith commission but I think it is something that could well do with being revisited.

Professor Ronald MacDonald: But then you are not really moving away from the sharing and pooling of risks that people voted for by staying in the United Kingdom.

Professor John McLaren: It adds a complication but I think it is such a fundamental difference between the two economies.

Professor Adam Tomkins: In the Smith commission we promised that there would be no running commentary on various different people's negotiating positions, but it is in the public domain that the Scottish Government would like to see taxes beyond those agreed by Smith added to the Scotland Bill. The focus is on employers' national insurance contributions, capital gains tax, the personal allowance in income tax and corporation tax. The focus of their attention is not on the North Sea. It was not glossed over by the Smith commission, it was discussed, and the volatility of the issue means that it would be much harder to see stable fiscal settlements in Scotland.

Professor John McLaren: It kind of hides where Scotland gets the benefit from. Scotland at the minute gets the benefit from the Barnett system but it is really coming from the North Sea, which is allowed through the Barnett system to flow in. Because that is not acknowledged definitively, again it makes it more complicated for people to understand the whole funding system and why Scotland potentially gets this extra money.

Professor Ronald MacDonald: I have always thought of the Barnett formula as like an oil fund; it smooths the revenues for Scotland.

Q26 The Chairman: One of the objectives of devolution surely is that it offers the devolved Parliament the opportunity to improve economic performance, and yet we have heard from Professor Trench that there is no comprehensive evidence internationally that devolution has any connection with growth.

Professor Ronald MacDonald: Devolution of tax powers?

The Chairman: Yes.

Professor Ronald MacDonald: I mentioned in my paper—and I know John and I have had a spat about this—that there is some evidence that corporation tax can stimulate economic growth. It is a perfectly respectable paper in a peer-reviewed journal where a lot of the fiscal devolution literature appears. There is evidence that an approximate 10% cut in corporation tax gives you a 1% increase in economic growth; that is a broad-brush figure. I think that it underpins what the SNP has been saying in terms of using that lever to boost growth. I am not convinced that it would be able to do that. I think that there are alternative ways of doing that which you could use your borrowing powers to do, but there certainly is some evidence to suggest that corporation tax can have that effect.

On the borrowing powers there is one footnote I would like to make. It is my understanding that the Scottish Government at the moment have the power to spend about £0.5 billion on infrastructure and capital spending—that was something related to the funding of the Forth road bridge—and they have not exercised that spending. That does contrast with what you were saying earlier about their position that they are against the overall austerity in the UK, but they have this power at the moment which has gone unused so far to spend about £0.5 billion on capital spending.

Lord Turnbull: You have a strange contrast where George Osborne talks a big game on austerity but does not practise it and the SNP rails against austerity but actually practises it.

Professor Ronald MacDonald: That is a good point.

Professor John McLaren: Changing taxes often can be swamped by other effects in terms of trying to grow the economy, so it is difficult to be sure. You might do something good and something bad happens on the other side. American corporation tax is very high. Economists could give you an idea of what things could change that would grow the economy, and most politicians do not do them because they feel that they are too difficult to do. For example, the Mirrlees report from the IFS had some very good suggestions in it, but a lot of them are extremely challenging politically—road charging and things like that—and therefore are not done. There is a list of things that would be top of economists' lists to do that are not done for challenging political reasons.

Q27 The Chairman: May I ask one final question before we wrap up? We talked about an independent organisation along the lines of the OBR and maybe the OBR itself. There has been some suggestion of a need for an institution to, as it were, mediate between the UK Treasury and the Scottish Government over the block grant and over all the things we were talking about earlier on. Do you think that that is a sensible suggestion and is it necessary?

Professor Ronald MacDonald: I think so. Given all the issues that we have talked about today about the block grant, whether it needs to be revised in terms of needs and so on, we do need an independent body moving forward, particularly one which offers transparency in the collection of tax data and indeed other data which we do not have at the moment, which I find extraordinary. We do not have a measure of prices in Scotland, for example.

Lord Lamont of Lerwick: Could you not apply that argument to the health service and say that there should be an independent body to decide what money should be given to health?

Professor Ronald MacDonald: The body has to be seen as impartial for deciding the overall block grant for health and everything else. I am not sure that you would need a separate body for health and the individual units of spending.

Lord Lamont of Lerwick: It just seems to me that to take away the right of those who are largely paying the bill not to ignore but to discuss and then decide may be a bit unreal.

Professor Ronald MacDonald: Ultimately, it would be the two Governments who would decide.

Lord Kerr of Kinlochard: Surely it depends whether they are discussing the size of the cake or the size of the slices? It would be for the Government to decide the size of the cake but the slices should be objectively cut, and that would be their job.

Professor Adam Tomkins: I would analogise a little with the Supreme Court. We have various devolution statutes which confer powers on devolved legislatures in different parts of the country and from time to time there will be border disputes. Is this Act of the Scottish Parliament within competence or outwith competence? It is not Governments who negotiate that between them. If there cannot be a political resolution, you go to court and the Supreme Court makes a determination as to what the law is. It seems to me that if we can do that with constitutional law, we can do that with constitutional economics.

Professor John McLaren: Says someone from a legal background! Inevitably it has to be politicians who make the final decision, or perhaps it should be left to the civil servants, and they will do a lot of the work, but ultimately it has to be the politicians who get a deal done.

The Chairman: Gentlemen, thank you very much indeed.