HOUSE OF LORDS

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Inquiry on

THE DEVOLUTION OF PUBLIC FINANCES IN THE UNITED KINGDOM

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2.45 pm and 4.45 pm

Witnesses: Sir Danny Alexander

Keith Cochrane, Professor John Kay and Professor Noel Lloyd

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Members present

Lord Hollick (Chairman)
Baroness Blackstone
Lord Forsyth of Drumlean
Lord Griffiths of Fforestfach
Lord Kerr of Kinlochard
Lord Layard
Lord May of Oxford
Lord Monks
Lord Sharkey
Lord Teverson
Lord Turnbull
Baroness Wheatcroft

Examination of Witness

Sir Danny Alexander

Q89 The Chairman: Sir Danny, thank you very much for joining us this afternoon. Thank you also for accommodating the slight change in the timing. We have a visitor this afternoon in the shape of the President of China.

Sir Danny Alexander: Let me apologise for my voice. I was at Twickenham on Sunday and have not recovered from the vast amounts of shouting that I was doing, sadly in a losing cause.

The Chairman: Have you spoken to the referee?

Sir Danny Alexander: I have not. I think he is best served by avoiding Scottish people for some time to come.

The Chairman: Perhaps I might start. You said to the Scottish Finance Committee in January this year that it was "essential that the fiscal framework is agreed by the Governments so that the House of Commons and the Scottish Parliament can hear about it when they consider the Bill to implement the Smith plan". Alistair Darling, now Lord Darling, made a similar point when we saw him—that it was really impossible to come to any reasoned conclusion without that—yet we have not seen a fiscal framework. How on earth is it possible, therefore, for Parliament and the Scottish Parliament to come to any sensible conclusion on this Bill?

Sir Danny Alexander: I hold to the view that I expressed before. I agree with Alistair Darling that it is important that before the Bill has completed its passage—I have not been following the Bill as closely as perhaps I would have been if I were still a Member of Parliament—Parliament has a chance to see and consider the fiscal framework. In a way, the fiscal framework that lies behind the Bill is at least as important as the things on the face of the Bill—the taxes that are being devolved, the welfare spending elements that are being devolved and so on—because ultimately the fiscal framework is the element that determines whether or not, for example, the principles of "no detriment" have been satisfied, that the economic incentives on both sides are properly set out and that there is a degree of simplicity and consistency to the way in which the new system will operate that means you will not have rows every year about how much money is changing hands. I would hope and expect that that work would be completed and Parliament could see it. Whether it needs to be available to Parliament at every stage of consideration is a different question, but I certainly think that that information needs to be available before Parliament as a whole has finished its consideration of the Bill.

Q90 The Chairman: The Government have been somewhat shy about appearing in front of us, because they clearly feel that it would be inappropriate to comment on negotiations as they are going through. One can understand that a little, but if that is going to deprive MPs, Peers and MSPs of vital information, how on earth can they come to any reasoned conclusion?

Sir Danny Alexander: MSPs, MPs and Peers are people who will have to make their own judgment on that subject. My perspective from when I was in Parliament and in government was that you have these core building blocks for the new system. You have the Barnett formula, which continues to exist but is much less important, you have the devolution of taxes and welfare payments, and you have a new fiscal framework behind it that ensures that the whole thing adds up. I would hope that both the UK Government and the Scottish Government were taking their responsibility seriously in terms of putting such a framework in place. I know that there are elections to the Scottish Parliament next year. It may be that the Scottish Government are worried about the political consequences of coming up with a new fiscal framework. It may be that there are delays in Whitehall. Who knows what the reasons are? However, this is a pretty centrally important part of the new system. You and your colleagues in the House of Commons ought to have some knowledge of that, I would argue, but I cannot give you any insight into what the negotiations are. I no longer have any such window on that.

Lord Forsyth of Drumlean: The Bill has gone through and has been discussed by the House of Commons without that fiscal framework being known to it. Do you think that it needs to go back to the House of Commons for consideration?

Sir Danny Alexander: I have not followed the parliamentary process enough really to have a view on that question. If your Lordships had access to that information, you could make any amendments that you felt were necessary, which would then go back to the House of Commons. That is the way that such things are normally accommodated in parliamentary procedure.

Q91 Lord Forsyth of Drumlean: Going back to your experience in the Treasury, a number of the witnesses have complained that in deciding on the funding, particularly of Barnett, the Treasury is judge and jury in its own court, and that there is a need for some kind of independent process. What is your view on that, now you are released from collective responsibility?

Sir Danny Alexander: First, I think that the Treasury has a core responsibility for the financial stability of the United Kingdom. It is right that it takes that seriously and does not contract it out. In respect of the Barnett formula, I do not accept the criticism. The way in which the Barnett formula operates is simple and transparent, for those who really care about the detail of how it operates. During my time in office, I do not recall once there being any great row or debate about whether or not the calculation of the Barnett formula had resulted in the right numerical outcome; I think that it is proposed that an independent body should oversee those sorts of calculations. I do recall that on one occasion there was an error on a spreadsheet, which was picked up pretty quickly by a civil servant and corrected.

One of the strengths of the Barnett formula is precisely that people might disagree about the politics that lie behind different policies—they might, for example, criticise the deficit reduction and the fiscal consolidation that has led to reduced spending over the years, which I support; I think that you do, too—but the rows tend to be at that level. In my experience, there has not really been a row, an argument or a question mark over whether or not the Barnett formula itself has been applied correctly. Incidentally, I think that that is one thing that needs to be replicated in the new fiscal framework. You need to have a new fiscal framework that is understood and predictable, so that you do not have rows every year about whether the right number has been generated as a result of it. Of course, that is one of the difficulties that will exist between the two Governments in terms of sorting this out, although I happen to think that there is a fairly straightforward way to do it, which we may come to. However, I do not particularly see the need for an independent body to oversee these things, because I do not think that there is any evidence whatsoever of Barnett calculations having been subject to any sort of trickery or difficulty, certainly not in my time and, I suspect, not in yours either.

Lord Forsyth of Drumlean: Actually, in my time we did all the time. We were constantly trying to fiddle it in order to get Scotland more money. That is one of the reasons why convergence has not happened.

Sir Danny Alexander: That is one of the differences between a coalition and a Conservative Government, I suspect.

Lord Forsyth of Drumlean: On the point that you made about not having an independent body, this is my concern, which reflects the evidence that we have had. You have just made the point that Scottish funding will be less dependent on Barnett because more of it will be dependent on raising tax from within Scotland's tax base. However, as Scotland's tax base is somewhat narrower than that of the rest of the UK, the likely outcome is that there will be less money available and, therefore, more argument about the extent to which the block grant is calculated. Would you accept that? If you accept that, is there not a case for getting the Treasury out of that argument, so that you avoid conflict between the two Governments?

Sir Danny Alexander: People cannot have it both ways. One of the consequences of devolution of tax power is that you are taking a greater degree of responsibility for funding yourself. That ought to create an incentive for the Scottish Government to adopt policies that expand the Scottish economy, improve the Scottish tax base and so on. The fiscal framework ought to be established in a way that gives fair reward for policies that achieve that but which also ensures that the Scottish Government take the consequences if their policies have the opposite effect. That is the nature of the responsibility. If you do not want to have that responsibility, you should not favour devolution, still less independence.

Lord Forsyth of Drumlean: I absolutely agree, but do you think that most of the people who say that they want this devolution realise that it will mean less money?

Sir Danny Alexander: I do not think it is axiomatic that it means less money.

Lord Forsyth of Drumlean: If your tax base is narrower and you are more dependent on the tax base, surely it does.

Sir Danny Alexander: Over time, that depends on the policies that are pursued by the Scottish Government and the policies that are pursued by the UK Government. People should realise that devolving taxes heightens responsibility in that way and means that if Scotland systematically pursues policies that scare away business, deter investment and stop people wanting to locate in Scotland it will suffer a fiscal consequence of those sorts of policies. It is a fairly modest fiscal consequence compared with that to which Scotland would have been exposed had we voted "yes" in the independence referendum.

Lord Kerr of Kinlochard: So you do not accept that it was a pity that the continuation of the Barnett formula was written into the vow, which is presumably immutable. It seems to me that the problem with the Barnett formula is, first, that I do not believe the outside world understands it, secondly, that it creates a genuine grievance for the Welsh—

Sir Danny Alexander: I am sorry, but could you repeat that? I missed the second point.

Lord Kerr of Kinlochard: It creates a genuine grievance for the Welsh as a result of its operation. Thirdly, it creates an ersatz grievance for the Scots. Scots are very good at grievances. The strange thing about the rugby match is that, for once, we really was robbed. *[Laughter.]* You defend the Barnett formula. You think that our predecessors in 2009 were wrong to recommend a needs-based system.

Sir Danny Alexander: In fairness, I fought the 2010 election on a Liberal Democrat manifesto that proposed a needs-based assessment. I changed my view on that during my time in office. I think that the process of moving from the Barnett formula to some sort of needs-based assessment would be lengthy and rancorous and would result in an outcome that had broadly the same results in terms of financial allocations as the system that exists at the moment, because that would be the nature of that sort of row. That would be a waste of everyone's time, effort and emotional energy.

What I want to see is a system that improves the degree of financial and economic responsibility that is taken by the Scottish Government and the Scottish Parliament. What we achieved through the vow and, particularly, through the Smith commission is a set of proposals that reduces the reliance, in the Scottish context, of the Scottish Government on the block grant from about 90% of its funding at the moment to about 35% of its funding once the Bill has come into force and all aspects of it have been implemented. That is a very big change. That is a much better way to handle this situation. I would defend the retention of the Barnett formula. My party changed its view on that. I do not think that any other party has argued for changing the Barnett formula. Rather than wasting our time with a massive row about something that will become progressively less important, I would focus on getting the fiscal framework behind the tax and welfare devolution right.

Lord Kerr of Kinlochard: I agree, of course, that working out and getting agreement to a new system would be a lengthy process. I wonder whether underlying your arguments there is not the Scottish heresy that any change would be further to the detriment of the Scots, which I think is completely invalid. It would entirely depend on the weight that you attached to the particular factors that you were addressing when you considered needs. If you gave great weight to sparsity of population, the Scots might end up better off. It seems to me that the Scots have always been wrong to resist the idea of having a look again at Barnett. It would be better to have a system that was based on clear principles that people understood. I accept that we are where we are and that this is—

Sir Danny Alexander: I am afraid that I disagree with you. Your point is right that, in developing a needs-based system, you have to decide which needs are important and what weight they have in an allocations formula and to work through what the financial results of that would be. That could lead to a myriad of different outcomes. Politics being what it is, it would probably lead to broadly the same outcomes that we have at the moment, just through different means. That would not be a productive use of time and energy, which could be better spent on getting the nature of fiscal devolution right.

Q92 Lord Sharkey: I would like to talk about how we make adjustments to the block grant. We have heard evidence on three main methods: the fixed percentage adjustment, just repeating the first year's percentage; indexing the whole thing to the percentage change in the rest of the UK's revenues; and indexing to growth in per capita change in the rest of the UK, in terms of revenue. All are very different, and all have different consequences. How do you think in general we should go about making these adjustments? Do any of the three that have been discussed appeal to you?

Sir Danny Alexander: Some form of tax receipts indexation to the tax receipts in the rest of the UK is the most logical and appropriate way of making the adjustment. You can have either indexation towards the total tax receipts or indexation to the tax receipts per capita, which was your third option. The first is probably a bit neater and easier to organise.

Indexation to the tax receipts means that decisions to increase or reduce taxation in the rest of the UK are reflected in the allocations to Scotland, but also that Scotland is able to take the benefit or pay the cost of its own policy successes or failures, while recognising that, if there is a recession that causes a dramatic fall in tax receipts, Scotland or, indeed, other devolved parts of the UK would be protected against that. The ability of a system to maintain the collective economic risk pooling in the UK financial system is a feature that needs to be retained.

Q93 Lord Teverson: Sir Danny, perhaps we could move on to the "no detriment" part of the proposal on fiscal devolution, which we have generally found quite contentious—particularly the second part of it. A number of our witnesses have questioned whether it is even really possible to apply and whether it should perhaps be seen as just a very high-level principle, rather than one that is looked at in the micro. What worries me about it in many ways is that the philosophy of "no detriment" leads to exactly the sort of rows we are talking about, if it is looked upon at all in a micro way. Does it mean that there needs to be a compensation to Scotland for whatever happens elsewhere in the UK and the Treasury, which leads to a ratcheting-up of the financial settlement as time goes on?

Sir Danny Alexander: The principle is a sensible one, as something that ought to be in our minds as the fiscal framework is constructed. There should be no detriment at the starting point and the means of adjustment should be devised to be as automatic as possible, so you do not have those rows, but to ensure that fiscal responsibility is taken in the appropriate spheres by the UK Government and the Scottish Government. The tax receipts indexation methodology Lord Sharkey referred to achieves that. It means, for example, that if the rest of the UK chose to increase taxes the block grant deduction would also be increased, but Scotland would gain the benefit of increased spending through the Barnett formula. The effect would be that increases in taxes in the rest of the UK would fund increased services in the rest of the UK, but the position in Scotland would be unaffected; likewise in respect of tax reductions. Your question has force only when you get into very small, micro-level decisions. I do not think that the "no detriment" principle should be read as meaning that every micro-level decision needs to be adjudicated by some sort of committee. Of course there will be areas where, at the margins, there are issues. Air passenger duty devolution is one such. Arguments have been made that airports in the north-east or, indeed, Bristol airport, in the case of devolution of air passenger duty to Wales, would lose out substantially. However, when you look at the numbers, the effect is quite small in macro terms. That level of things can be absorbed by the relevant Government.

Lord Teverson: On a related issue, particularly looking at those minor taxes and things, one of our witnesses made the point that any taxation change in the UK will effectively affect Scotland in some way, because of adjustment mechanisms like "no detriment". Does that make the whole question of English votes for English laws very difficult to define in the House of Commons? Does it make it all impossible?

Sir Danny Alexander: I fear, Lord Teverson, that you are drawing me on a subject that is beyond the scope of my evidence. I always thought that English votes for English laws was pretty hard to define in the first place. In the end, the only way really to have that organised in a sensible way is through some sort of wider constitutional change in the United Kingdom. You and I might agree about that, but we would probably also agree about how far away it is.

Lord Teverson: I suppose that I am asking whether in a practical sense, given your knowledge of the financial system, this makes it a lot more difficult than perhaps people think.

Sir Danny Alexander: It means that there are decisions made in England that may apply in England only but that have an economic effect in Scotland and Wales, and therefore that Scottish and Welsh devolution should be taken into account within the parliamentary debate. Incidentally, you might make the same argument that decisions made in the Scottish Parliament have an effect on the north of England, for example, yet those voices are not weighed. If the Scottish Parliament is debating things like whether to reduce or increase its top rate of income tax, that might have an effect on people moving backwards and forwards across the border and on where businesses choose to locate either side of the border. The argument cuts both ways, but one has to be pretty careful to say that Scottish voices should be excluded in a parliamentary sense on decisions that have a knock-on effect in Scotland.

Structures also need to be put in place around the fiscal framework. A body called the Joint Exchequer Committee was established. I am not sure that it was all that effective in my time, to be honest with you, but it had Finance Ministers from the Scottish and UK Governments, which allowed some of these issues to be debated and discussed and allowed consequences to be weighed and so on. That sort of co-ordinating mechanism will be much more important, given the scale of fiscal devolution that is now being talked about. It might allow some of those issues to be weighed up in a practical way.

Lord May of Oxford: I have a possibly silly question. I confess that I do not understand all of this as fully as I would like, but it seems to me that it is all really rather complicated. I do not think that it can be defended as a system that will make it simpler to run, and complexity carries a cost. This interplay, so much of which is generated by ambitious and idealistic commitments of certain people, seems to me to have a fair potential for working less well than what we have now. Would you explain to me what is wrong with that argument?

Sir Danny Alexander: First, I do not think that it is particularly complicated.

Lord May of Oxford: You are right in the middle of it, but I must say that it does not read or sound simple.

Sir Danny Alexander: The amount of money available to be spent in the Scottish Parliament will be the block grant, as calculated by the Barnett formula, with a deduction for the devolved taxes, adding the amount of revenue raised in Scotland directly by the taxes that have been devolved to it and some further grant for the welfare areas that are being devolved. It is the sum of four things. Of course, there is complexity in how you calculate those four things and so on, but ultimately it is about having a system that operates UK wide—the Barnett formula—and trying to enhance the financial responsibility and accountability of the Scottish Parliament by giving it control over money raising and deducting money from the formula for the money raised. Then you have welfare. We have not talked about welfare, but obviously there will need to be an adjustment mechanism for how the welfare supplement is uprated year by year.

Each of those is complicated when you go into them. When you go into the Barnett formula, it is complicated. You have to look at the comparability factor in population weighting for each and every area of public expenditure, and there are thousands of them in the spreadsheet. I expect that very few people have studied that spreadsheet. I have had the misfortune—or the good fortune, perhaps—to be in that position, but the operation of it is fairly smooth. The point that I am trying to make is that in devising the new fiscal framework trying to replicate the smoothness and automaticity of the Barnett formula is really important. You should not be having rows every year about whether or not the adjustment process is fair. People can have rows politically about whether or not they think that there should be fiscal consolidation, or they can have rows in the Scottish Parliament about whether they should have higher or lower taxes in Scotland. That is what the rows should be about. It is not straightforward to work out precisely how you do that, but the model itself is fairly straightforward.

Lord May of Oxford: However well intentioned and however good an idea this is, it sounds to me like it will create quite a large number of new jobs, so one of its benefits will be reducing employment. I am not altogether being sarcastic.

Sir Danny Alexander: Who knows? There may be a technological solution. Maybe there can be an app that works it all out and you can have fewer people working on it. I do not know.

Lord Forsyth of Drumlean: Going back to the "no detriment" principle, I am sure that I must have got this wrong—like Lord May, I think that it is a bit complicated—but under the Major Government, for example, in England they decided to privatise water and in Scotland we decided not to privatise water. The result of that was that all of the money that was spent in the public sector on water was no longer part of the Barnett consequences.

Sir Danny Alexander: That is right.

Lord Forsyth of Drumlean: We therefore lost 10% of what was being spent on water through taxpayers' resources in England; instead people paid for their water through charging. Does the "no detriment" principle really mean that if, for example, that were to happen now—if something like water were no longer part of the public sector—the English taxpayer would have to send a cheque north of the border to compensate the Scots for the fact that they were not doing the same thing? Is that really practical politics?

Sir Danny Alexander: No, I do not think that it means that. I do not remember all of the details of that. You were involved in it, obviously. I think that I was at university at the time—

Lord Forsyth of Drumlean: Let us not talk about that example. Let us take any example where—

Sir Danny Alexander: Let me just work it through. The consequence of that would be a reduction in public expenditure in England. In that case, an item is simply taken out of the Barnett formula. However, let us suppose that expenditure in the Department of Health is reduced in England; that might be an equivalent example. If spending were reduced, the Barnett consequential would be that the Scottish Government would get less money. Under the new system, unlike at that time, the Scottish Government would then have a choice. Do they want to increase taxes to raise more money to cover the cost? That was not an option available when water was privatised.

Lord Forsyth of Drumlean: I am talking about "no detriment". What I understand "no detriment" to mean is that each side compensates the other for changes in policy. To take your own example, if in the health sector it is decided to have more charging for prescriptions or something of that kind—no, that does not work. Take my example. You decide not to do something, which results in less public expenditure and a reduction in the Barnett consequences. My reading of the legislation says that they have to send a cheque to the Scottish Parliament to compensate it for the change in policy in England. Is that wrong?

Sir Danny Alexander: Yes, I think that is wrong.

Lord Forsyth of Drumlean: So what does it mean?

Sir Danny Alexander: What it means is two things. First, when you set up the system at the start—

Lord Forsyth of Drumlean: No, this is after that.

Sir Danny Alexander: The initial adjustment should be—

Lord Forsyth of Drumlean: No, this is the second—

Sir Danny Alexander: I understand. The initial adjustment is one that should not have any effect. Then the fiscal framework that you establish should not in itself cause gain or loss to either side systematically as a result of the way that it operates. In this case, just as at the moment, that change would be captured within the fiscal framework, so I do not think that it would require some other decision-making to go on top of that.

Q94 Lord Griffiths of Fforestfach: Sir Danny, do you think that the choice of taxes that are being devolved was based on principles, or do you think that it was just horse-trading?

Sir Danny Alexander: It could be both. Of course, within the Smith commission it was based on trying to get a consensus among five political parties with quite different views around the table. However, there is a quite sensible principle that would support devolving personal taxes, meaning income taxes, while retaining control of business taxes—taxes in the UK single market, if you like—at UK level. You could rationalise it in that way. Certainly, that is how I would defend not devolving corporation tax or North Sea tax duties but devolving income tax. Sharing VAT revenues would be another example. Part of what is behind it is, how do you retain the financial integrity of the UK single market in a situation where there is greater devolution and not just allow harmful tax competition, which results in a race to the bottom? That would be a risk with some of those business taxes.

Lord Griffiths of Fforestfach: Gerry Holtham suggested that the tax base should be as immobile as possible. If you look at income tax, I wonder whether with tax competition and so on, possibly with people moving, you are not using something that potentially could become more mobile.

Sir Danny Alexander: The answer, of course, is that, in the extremes, people might choose to move because of the tax regime. I often think that that argument is somewhat overstated. If Scotland chose to increase its top rate of tax to 60%, say, I suspect that you would see some movement going on, but it is much less mobile than some other taxes. Of course, that is part of the responsibility that you have to take as a Government with responsibility for income tax. That is the same responsibility that the UK Government take for the tax rates that we set and the effect that those have on whether people choose to locate in London, in New York, in Paris or wherever. Again, there is a risk, but it is the sort of risk that a financially responsible Government ought to be weighing up in their decisions.

Q95 Baroness Wheatcroft: Could we explore income tax a little more—in particular, whether you agree with the decision to devolve 100% of income tax? Is there not a risk that, emotionally at least, that takes a step closer to independence, rather than devolution? Alistair Darling raised the issue of what involvement one feels in defence, for instance, if 100% of your income tax is going to the Scottish Government.

Sir Danny Alexander: I see the argument. My response would be that I am not so worried about that, because in the UK we have two forms of income tax. One is called income tax and the other is called national insurance, but they are both income taxes.

Baroness Wheatcroft: But they should be one, really.

Sir Danny Alexander: Maybe they should, although doing so is rather complicated and difficult. We could dwell on that on another occasion. Your national insurance goes entirely to the UK Government. That is a contribution to what the UK Government do and is paid by everybody. Your income tax goes to the Scottish Government. Given that we have two income taxes, one that will effectively be fully devolved and one that is fully reserved, to my mind that maintains the sense that everybody is making a contribution both to services in Scotland and to services at UK level.

Baroness Wheatcroft: Is the fact that tax on savings and dividends will not move a purely pragmatic solution with which you are quite comfortable?

Sir Danny Alexander: It is purely pragmatic. Devolving those things is very complicated. Probably the complexity would cause more trouble than it was worth.

Q96 Baroness Blackstone: What limits would you place on additional borrowing powers for Scotland?

Sir Danny Alexander: There is quite an interesting choice here. First, in a sense we are talking about two kinds of borrowing. One is borrowing to manage income fluctuations. The current arrangements, as you know, mean that there are current borrowing powers of, I think, from memory, up to £500 million. There are then capital borrowing powers. The current borrowing powers need to increase. A greater amount of tax is being devolved, so there is a greater amount of year-by-year volatility the Scottish Government would need to be able to borrow for. That should be within limits, but those limits might be two, three or four times greater than those that exist at the moment, depending on the total size of the taxes being devolved.

With the capital borrowing, we currently have borrowing within a limit of about £2.2 billion, I think—it may be a bit more these days—but uprated.

There is an option to say, "Let us get rid of the capital grant that goes through the Barnett formula and replace it with a prudential borrowing power of the sort that local authorities have for devolved Governments". That might be preferable, because it would give full control over capital spending amounts year by year to the Scottish Government—provided that there is a form of the prudential code that the Treasury can trust, so it will not result in excessive borrowing that cannot then be repaid. That would be consistent with the direction of policy. I never formed a view on that when I was in government, because there are pros and cons on both sides, but the idea of a prudential borrowing arrangement for devolved institutions should be given really serious consideration. It might well enhance responsibility, enable better planning of infrastructure and capital projects and avoid the sorts of oddities that you have when you have quite a strict capital budget but very big and lumpy projects to pay for within it.

Baroness Blackstone: Some people have argued that the UK Government should legislate against any bail-out of the Scottish Government. What is your view on that, if there is irresponsible overspending and so on?

Sir Danny Alexander: The Scottish Government should not operate on the basis that if they make mistakes with their borrowing they will be bailed out. In a unitary state, the markets will always believe that in the end there will be a bail-out, exactly as they believe that with local authorities in the UK, with their current borrowing arrangements. I am not entirely sure how you manage that. In practice, local authorities have a very clear understanding from the central government that they will not be bailed out, while at the same time having the benefits, through the Public Works Loan Board or the national loans fund, as it is now organised, of the low interest rates that the UK sovereign can command. However, the markets would probably assume that, in extremis, there would be a bail-out.

Baroness Blackstone: In other words, legislation would be too inflexible and you would not be in favour of having a really tough regime that said, “Legally, there is no bail-out”.

Sir Danny Alexander: You absolutely need to avoid the moral hazard, but that needs to be codified in the borrowing arrangements that exist within the UK. Of course, the Scottish Government would have the ability, if they wished, to raise bonds of their own on the market. That is a power that has already been devolved. In value-for-money terms, they would be very unwise to do so, because they would pay a premium, even within the UK, for issuing their own bonds. There would be relatively small numbers, there would be very little market for it and there would not be much liquidity in the market, so there would be an interest rate premium to be paid. If they are borrowing through the UK Debt Management Office and taking advantage of the strength and credibility of the UK sovereign, they ought to be subject to constraints, to avoid the kind of moral hazard that you describe, but I am not sure that legislation is really the right place to do that.

Baroness Blackstone: You would instead have limits on borrowing powers.

Sir Danny Alexander: You should look at the way the prudential borrowing arrangements for local authorities in the UK work. There are not any formal limits within the prudential code, in terms of cash amounts. Instead, the code requires that any bit of borrowing is against an income stream that is demonstrably able to repay it. Putting in place a code of that sort might well be appropriate in the context of a devolved situation as well. I am sure that you will ask others, but the widely held view is that the prudential code works pretty well. The Treasury is able to predict pretty accurately borrowing that takes place and there are very few examples of irresponsible borrowing taking place, because local authorities simply do not expect that that will then be bailed out in a way that is cost free to them.

Q97 Lord Turnbull: I was somewhat surprised at your robust defence of the Barnett formula. I think that there is a manifest unfairness in it that has persisted unchallenged for 40 years. It is supposed to produce convergence of public expenditure per head, but it has manifestly not done that. It has allowed these divergences not only to persist but actually to increase. The evidence of that is that it has become so unfair that the UK Government have had to introduce a compensatory mechanism, the funding floor for Wales. Why are you so complacent in allowing this failure to produce any convergence to exist? If you were Welsh, would you be saying something different?

Sir Danny Alexander: I cannot imagine myself into the last part of your question. I am not sure that I have much to add to what I said before. In any system for allocating funding, you need to have a number of things. It needs to operate on a practical basis that is smooth and predictable and in which people feel confidence, so that from a practical point of view it works well. You are right that in Wales there is a particular grievance about convergence. That has led to discussions about a Barnett floor, although it is worth noting that in a period of contracting public expenditure there is divergence going on again. When the state's budget is shrinking, you do not see that convergence happening. That is something that will take some time to reassert itself. My argument is based on whether, as a former Member of Parliament and a former Minister and politician, I think that the process of putting together a needs-based arrangement would result in something that had materially different outcomes overall. I do not think that it would.

Lord Turnbull: Can I ask you about that? If you had a needs-based arrangement, you would probably have five variables: how many people—

Sir Danny Alexander: You say that you would have five variables. I suspect that people might—

Lord Turnbull: Holtham argued that you would catch most of the data with a small number: the number of people, the number of old people, the number of young people, some measure of income and sparsity. Incidentally, I do not agree with John Kerr that sparsity would be particularly relevant, because the number of people who live in the sparse areas is so small. They are all in Glasgow and Edinburgh.

Sir Danny Alexander: I would argue that sparsity is extremely important.

Lord Turnbull: For a small number of people.

Sir Danny Alexander: That is because I come from the highlands—exactly. Everybody would argue the importance of the different elements, depending on where they came from and what interests they were representing. The ability to have an objective discussion on this is very limited.

Lord Turnbull: But precisely these variables are already in use in various parts of the UK public finances, and people are not arguing that it is impossible to use them. You say that you do not think that it would produce much difference. Why do you not find out? Why do we not do an exercise and see how difficult it is and what the result is?

Sir Danny Alexander: I am not doing it, but I am sure that your Committee is welcome to try. *[Laughter.]* I look forward to seeing the results.

Lord Turnbull: Do you think that it would produce expenditure per head in Scotland 20% higher than that in England?

Sir Danny Alexander: It might; it could well do. You mentioned five variables. You might look at life expectancy. You might look at some of the indices of health inequality. You might look at educational attainment. There is now a whole range of variables that people who are constructing policy seek to target. You think about the attainment gap in education. That is a very important variable that, certainly under the coalition, the UK Government were seeking to target.

Lord Turnbull: But that is an indicator of how successful the outcomes of spending the money are, not of what the need is.

Sir Danny Alexander: Is that really correct? If 30% of young people are failing to achieve a basic standard in education, you might argue that that means there is a need for improved education.

Lord Turnbull: But they have had a lot more money spent on them.

Sir Danny Alexander: Maybe, maybe not. The point that I am making is that one could have an endless debate about which variables you would choose. There would be voices from all sides of the United Kingdom who would choose the variable that best suited them and argue for it to be weighted in a particular way. I think that the way in which our public finances in the UK should develop is through greater fiscal responsibility being held closer to people, through devolving tax-raising powers and through the sort of borrowing for capital that we were talking about earlier. It is much more fruitful to concentrate on getting that right, rather than having—

Lord Turnbull: Are you arguing that the present structure—the Smith structure—does not have enough tax in it and has too much grant?

Sir Danny Alexander: No, not necessarily. I think that the balance is pretty good. Over time, depending on the fiscal framework that is put in place and the way in which the welfare side of the equation develops, you will see the importance of the Barnett formula being considerably less than it is at the moment. Last year, 90% of the money spent by the Scottish Government was derived from the block grant. When all of this system is in place, it will be a third or so. The financial responsibility to raise money and the accountability that that generates are the consequence of devolution.

The Chairman: In the one minute that remains, I turn to Lord Kerr.

Lord Kerr of Kinlochard: Are you sure that you are not coloured by your experience as an extremely distinguished Chief Secretary to the Treasury when you say that over time the "no detriment" principle will work perfectly well, people will accept the rough with the smooth, there will be give and take and there is no need to open the black box at all—no need to have the principles laid out, no need to have any independent monitoring body and no need to have any transparency?

Sir Danny Alexander: No. I think that the principles and the way in which this works should be laid out. There needs to be some mechanism periodically for that to be discussed between the Governments and for the outcome of that to be something that is public and scrutinised by both Parliaments. We currently have a thing called the statement of funding policy—I am sure that you have all read it—which sets out how the financial arrangements are supposed to work. That is reviewed periodically. The thing that needs to be conducted absolutely independently is the economic forecasting that lies behind a lot of the tax and spending decisions that are taken, but I am not convinced at all by the argument that you need an independent body to oversee all of this. In a way, that might just lead to the independent body being in receipt of all sorts of bogus grievances that are generated simply for the purposes of publicity.

The Chairman: Heaven forbid.

Sir Danny Alexander: Heaven forbid, my Lord Hollick. *[Laughter.]*

The Chairman: Sir Danny, thank you very much for your helpful and informative answers.

Sir Danny Alexander: Thank you.

Examination of Witnesses

Keith Cochrane, Chief Executive, The Weir Group, **Professor John Kay**, Visiting Professor of Economics, London School of Economics, and **Professor Noel Lloyd**, Member, Silk Commission, and former Vice Chancellor of Aberystwyth University

Q98 The Chairman: I welcome you all to the Committee. Thank you for your forbearance. We had to pop downstairs and meet the President of China, who made some very nice remarks about the great links between our countries. He seemed to be looking forward to his fish and chip dinner in a pub. That all went down very well. I am conscious of the fact that by moving this session we have a very tight timetable, so we will stick strictly to one hour.

Could I start by asking you to what extent you think the choices of taxes that are being devolved have been governed by any principles? As a follow-up, should corporation tax have been devolved to Scotland and Wales? Who would like to start?

Keith Cochrane: Perhaps, my Lord Chairman, I could start. For me, the fundamental principle is driven by the desire and, indeed, the need to give more accountability and more responsibility to the Scottish Parliament. Against that context, devolution of income tax is in reality the most practical and sensible choice to enable that to take place. Clearly, it does not result in a straightforward system going forward. There will be some complexities, no doubt. Our own thinking had been that, while the tax rates themselves could be devolved, perhaps the bands and the underlying legislative processes would remain consistent across the UK. The latter piece is certainly the case, but the former is not. There is a risk of more complexity given the approach that has been taken.

In terms of your second question about corporation tax, I and my company, the Weir Group, have been very consistent in saying that one of the most important benefits of the union has been the maintenance of a free market—the ability to trade freely right across the United Kingdom—and the challenge in doing anything with corporation tax is that it risks putting a question mark against that ability, and indeed introducing a lot of complexity for business. It was wise not to devolve corporation tax.

Professor Kay: If one looks at what taxes it is sensible to devolve, the first question to ask is how easy it is to attach a location to the thing you are trying to tax. Of the three big taxes in the UK, which are income tax, VAT and national insurance, VAT is a transactions-based tax that we cannot devolve for EU reasons; income tax is basically about residence; and national insurance is about workplace. Either of those are not bad from the point of view of attaching a location, but there is a good reason for not choosing income tax rather than national insurance, which is that national insurance is tied up with the benefits system, which you are not devolving very far. That is a sensible choice. If you go down the list of large taxes, the next one you come to is corporation tax, which is probably the hardest of all taxes to attach a location to. It is, basically, not working globally at the moment because of the difficulty of making that attachment. You then get down to the next group, which in order of size are fuel duties—really problematic to put a location on by the very nature of the tax—and business rates and council tax, which are, sensibly, devolved. In terms of underlying principles, the choice of devolved tax has been quite sensible.

Professor Lloyd: Going back to the work that we did in the Silk commission—my interest in this—on the devolution of financial issues to Wales, we initially established a set of priorities and criteria in terms of accountability, empowerment, incentivisation and stability. We checked, in a sense, every possible tax against those principles and came up with a very similar list, in that it needed transparency and stability for income tax and the smaller taxes, which in those days was stamp duty land tax. It is interesting that, working from those principles, we came up with a similar list of taxes to be devolved as is happening in Scotland. We looked very closely at corporation tax and, indeed, spoke to colleagues in Scotland and Northern Ireland. We came to the conclusion that it would not be sensible to devolve corporation tax. It is volatile to start with, it is unpredictable in some ways in terms of location, and it is a very complicated tax to operate. Against our principles, we were quite firmly of the view that, unless and until it was devolved to Scotland and Northern Ireland as well, we did not think it was useful to devolve corporation tax to Wales.

The Chairman: Did the commission look at the merits or otherwise of devolving tax on oil and gas from the Scottish part of the North Sea?

Professor Lloyd: We were not looking in particular at the Scottish element of it, obviously, but for other taxes we did a survey of the others and felt that in terms of Wales it would not make sense to have devolution. One of our principles was that, just because it was happening in Scotland, it did not necessarily mean that it would be good for Wales. One has to address the conditions in Wales, which may on some occasions be different from those in Scotland.

Lord Forsyth of Drumlean: I would like to comment on the principle of using income tax. Perhaps this is a problem that I have. I live in Scotland and I end up paying my income tax, which goes towards running the Scottish Parliament. On the question of accountability, if all my income tax is going to that purpose, I have no real interest, do I, in what is spent on defence and non-devolved issues? Is it not rather unusual—I cannot think of even a federal system—that all the revenue comes from income tax? Normally, you have a proportion that is then allocated in a particular way. It may be convenient, but it is not clear to me that the principle is right.

Professor Kay: Your VAT is going on defence and other non-devolved functions.

Lord Forsyth of Drumlean: I understand that.

Professor Kay: If there were freedom on VAT, one might well wish to do rather more. Clearly, the compromise by which part of the VAT is allocated to Scotland is a rather unsatisfactory one. Equally, there is probably more difficulty in pinning down the location of VAT.

Lord Forsyth of Drumlean: Of course, VAT is not a progressive tax. It is regressive.

Professor Kay: Yes. That is an interesting question. Given that we are in a United Kingdom, do we want there to be more progressivity, or an opportunity to have more or different progressivity at the devolved level? That is an issue about which you can argue, and one of the key moves in the Smith commission is to change that, to give some opportunity for Scotland, if it wants to have a more progressive tax system, or less.

The Chairman: But is there not a contradiction? Devolution—let us call it devo-max—or a significant amount of devolution is in order to provide the devolved part of the United Kingdom with the levers to improve their own economy, to improve their productivity. Many countries have used tax to do that. It seems to me that this is a natural direction of travel for the devolved Scottish Parliament.

Professor Kay: Yes, I think that is right. Lord Forsyth, to my mind, raised the question of what is the object of devolution in the first place, which is really the question from which you ought to begin all discussion. One of the problems of this discussion is that that is not where it began.

Q99 Lord Turnbull: We have a mixture of devolved taxes, shared taxes and direct grant. I get the impression that if you take the big picture you seem to be reasonably satisfied that it is better than the status quo, and in particular that one of the festering sores of all this in the

Barnett formula, the direct grant bit of it, is now substantially reduced. Are you roughly satisfied, and if you had actually been on the Smith commission yourself is there anything significantly different that you would have done?

Professor Kay: Given the direction that the Smith commission was forced to go in, in effect by the political situation, I do not think I would have wanted to do anything radically different. I agree with Mr Cochrane that the primary purpose had to be to try to raise the tax-raising powers of the Scottish Parliament to something rather more commensurate with its expenditure levels than the status quo allowed.

Lord Turnbull: We have had in the past a Scottish income tax power, never used. Do you think this income tax power is going to be significantly used?

Keith Cochrane: That is a very interesting question. One of the challenges will be for the Scottish Parliament to move itself from a debate only about outputs to considering the inputs necessary to deliver those outputs, which again gets to the heart of what is to be achieved in terms of providing, if I might say it, a sensible dose of reality to some of those discussions and understanding the consequences. There will have to be trade-offs. We are already hearing that in terms of some of the comments from political parties. Frankly, I am of the view that the sooner those powers are transferred and active in Scotland the better, because it will change the debate. It will ensure that at the next Scottish parliamentary election, which takes place next year, this will become a very real issue and start to inform the debate that the electorate of Scotland can opine upon.

Professor Lloyd: Although in Wales we are coming from a slightly different position in terms of quantum, the principle that Mr Cochrane mentioned, of ensuring that the Welsh Government have responsibility for raising taxes as well as spending taxes, is roughly what we mean by accountability, but also in terms of giving the Welsh Government an opportunity to develop the economy in terms of incentivisation. One of the cornerstones of the recommendations of the Silk commission is that the Welsh Government should have that opportunity to develop the economy of Wales by having those responsibilities. We were very keen on that. To answer the question about those powers not being used in Scotland to date, that is why the Silk commission was very keen to ensure that the bands of income tax could be changed independently—the lockstep issue—rather than tied to each other. We felt that perhaps the reason for not using it in the past was that you did not have that flexibility and that if you changed the standard rate you had to change the higher rates in the same way. Although having that independence was initially turned down by the Government of the time, it was changed. In the Wales Act 2014, that independence on possible changes was agreed. You might see a very different situation in the future given that that lockstep has been removed.

Lord Turnbull: Is it right that the only thing that is common is the first band, where the basic personal allowance is common?

Professor Kay: And the base of course. It is not as simple as saying that the personal allowance is common, because there would be nothing to stop you having a zero rate on, say, the first £1,000 of taxable income, or there is nothing that I can see that would stop that. It might possibly be something the Scottish Government would consider doing, because from where the Scottish Government are now they absolutely have to do something; the business of not doing anything, which has been true up to now, is now impossible. Having made a great song and dance about the need for more powers, you cannot then say, "Now we have got them, we are not going to exercise them". But then what is discovered is that the amount of money that comes from tinkering with the income tax structure is quite a lot less than people believed. I have sketched out what really would be the most draconian sets of innovations and adjustments you could make without prompting mass migration from Scotland. That might raise an extra two to three billion.

Lord Turnbull: What was the size of your threshold?

Professor Kay: I was going to leave the threshold, and I was going to knock all the rates of tax up by five points, so it would be a basic 25% rate of income tax in Scotland. It is only from the basic rate that large amounts of money come.

Lord Turnbull: First of all, what revenue would it raise, and do you think that would have people scurrying for the border?

Professor Kay: That package would raise £2.5 billion or so, which is about 6% of total Scottish Government expenditure—less, rather paradoxically, than the amount per capita by which public expenditure in Scotland currently exceeds the UK level.

Lord Turnbull: Right. I think that others will take that. Let me ask one last question about Wales. Having seen the Smith package, are there any bits of it that you would significantly not want to adopt or do so to a lesser extent?

Professor Kay: There is the big question, to which I am sure we are going to come.

Professor Lloyd: In general terms, the Smith recommendations were not very different from the ones that we had recommended. Going back to the mixed economy of a smaller proportion of income tax being devolved than is now proposed in Scotland, it is right for Wales, because it is a very different situation in terms of what is sometimes called the porousness of the border, with 90% of the working population of Wales living within 50 miles of the border. You have a different situation to take into account in terms of migration. Our feeling was that a mixture of shared income tax base would be appropriate for Wales. Perhaps the argument in Scotland is slightly different.

Q100 Baroness Blackstone: How easy is it going to be to identify Scottish income taxpayers? Are we being too ambitious in aiming for 2017-18 for the introduction of the new powers? Is it going to put the tax authorities under so much pressure that they will not be able to complete this adequately?

Professor Kay: I do not have particular knowledge of the administrative side of this. In the case of most people, it is not very difficult to determine where their residence is. The trouble in this case, or perhaps in any case, is that the people for whom it is more difficult tend to be the people who have the money. If you look at who the additional rate taxpayers are, there are something like 15,000 of them in Scotland. Most of them, one suspects, work in Edinburgh in financial services or in activities related to it. I suspect that a high proportion of those people have some base in England as well. That is the difficulty, and that is why I am sceptical about how much of any revenue would be raised by adjusting the additional rate of income tax, which is the one commitment that all the parties in Scotland seem to have made so far.

Lord Forsyth of Drumlean: There is also the point that dividend income will be taxed on a UK basis. If you have more than one job, you simply set up a company and pay yourself in dividends.

The Chairman: I think we should try to avoid giving tax advice.

Lord Forsyth of Drumlean: I was not giving advice. I was pointing out that there is a big hole in the bucket.

Q101 Baroness Wheatcroft: The Barnett formula is something that even the late Joel Barnett thought had outlived its usefulness, but it is pivotal to what is going on here. Do you think that that is a sensible way forward, or should there have been an adjustment based on needs? Should it be far more needs based than what we are looking at at the moment?

Keith Cochrane: I cannot claim any specialist knowledge on Barnett. My own perspective—it may be very simple—is that, given the complexities that are clearly inherent in the way the current formula works and given the substantial change that is taking place, can we not just draw a line and say, "This is the amount of block grant. It was set many years ago, subject to many different factors, which everyone would recognise have moved on, potentially to date. Is it possible to make a fresh start?" The biggest challenge with Barnett, and the challenge we have going forward, particularly against a means for adjustment, is that it becomes a perpetual debating ground. I would be very keen, but I will let my learned colleagues here comment upon whether it is possible. In my own view, if you could come up with a transparent, straightforward, visible—I am not going to say understandable, because I doubt it will be understandable to the average layman; but at least visible—and objective means by which—

Baroness Wheatcroft: It might be more understandable.

Keith Cochrane: It might. I completely agree. That would create a far better platform. My fear is that, if we do not address it appropriately, all we are going to do is create problems down the way, because there will inevitably be debate and indeed dispute about the adjustments that are going to be made. Having clarity, transparency and objectivity, perhaps involving an independent body in some form of review mechanism, from my perspective, as a businessman and certainly not an economist, would be the right thing to do.

Baroness Wheatcroft: Professor Kay, is it an opportunity wasted?

Professor Kay: Yes and no. If you were starting again, you certainly would not start from here. That is for sure. The core problem, which people do not want to talk about too much, is that if we move to a more objectively based system, unless you decide that the oil is Scotland's, and at current prices even if you do decide that the oil is Scotland's, Scotland gets too much. That is a fundamental problem in moving to a more sensible basis for the formula, and is why no one has been anxious to reopen this on either side.

Professor Lloyd: The Barnett formula is something that excites a lot of people in Wales, because there is a feeling that Wales is underfunded as a result of the formula. In terms of the commission, it was outside our terms of reference, although in our evidence gathering we received a large amount of evidence on the problems of the Barnett formula. One thing I would say, and of course everybody agrees, is that we would not start from here. Transparency is important. There are mechanisms for establishing a formula on some kind of needs basis. One of our predecessor commissions in Wales—the Holtham commission, which reported to the Welsh Government, not to the Westminster Government—proposed a mechanism by which that could be done. It was quite complicated, and in terms of public understanding there would be a challenge, but it is possible to do it, and it is done elsewhere, of course. Internationally, there are other examples of attempting to do it. Ideally, I suspect that most people in Wales would say that, yes, there should be a needs-based formula, but the political situation is such that it is not very easy to achieve, although with the changed scene in Scotland, with considerably more tax being devolved, there might be an opportunity. I emphasise that it was outside our terms of reference, but transparency and simplicity are what is required.

Baroness Wheatcroft: Added to that, Mr Cochrane suggested an independent body to determine what the grant should be. Is that something that you think would be an advantage, Professor?

Professor Lloyd: There are examples of that. Australia is one example, is it not? Certainly one needs a transparent mechanism, which might be intergovernmental or independent, to try to establish that, but that is a political decision.

Professor Kay: The independent commission route is clearly the sensible route ahead. The Australian system seems to work pretty well, although there is almost no example—I do not think there is any example—of a system of this kind where one of the units you are talking about is 85% of the total. That is a particular difficulty here. As the Australian story will tell you, it achieves objectivity and it is widely admired for that. On the other hand, everyone wants to introduce in taxation areas simplicity, transparency and so on. The trouble is that it is too hard to get simple, transparent systems. A system that achieves the variety of objectives you have is almost inevitably complicated. There is no simple interpretation of what one means by needs when one talks about a needs-based formula. That opens the debate rather than closes it.

Q102 Lord Griffiths of Fforestfach: I have a question for Professor Kay. Do you think that the OBR would be sufficiently independent to be an “independent commission”, or do you think we need to create another bureaucracy?

Professor Kay: It is possible that the OBR could do the job. It will create enough bureaucracy anyway, even if it is part of the OBR. It is a possible role for the OBR as a possible carrier of this particular load..

Lord Kerr of Kinlochard: Going back to Professor Kay, you say it is too incomprehensible to be transparent. If it is too incomprehensible to be transparent, it is unacceptable. It cannot be a firm continuing basis. We are stuck with it, I agree, because of the vow and all that, but should we not be using this Parliament to think of a long-term solution? I do not really buy your argument, Professor, that we are stuck with it because any needs-based alternative would be less good for the Scots, so they will not agree. Surely, that entirely depends on what weight you put on the factors in assessing needs. If you think it costs more to provide education, health or whatever at an acceptable, common UK level in the highlands and islands of Scotland, it is conceivable that you might produce a system out of which the Scots did better. It would certainly be easier to comprehend. If it is incomprehensible, surely it is unsatisfactory.

Professor Kay: I agree entirely that it is unsatisfactory, and I agree that the Barnett formula with the adjustments that have been put in place is not sustainable on a long-term, or possibly even quite a short-term, basis. It is going to be a starting point for contentious argument. The issue I would disagree with you on is that while it is true that it costs more to provide health and education in the highlands of Scotland, it does not cost so much more. Actually, the highlands and islands of Scotland are not where most of the Scottish population live. If you say how much would be justified on a needs basis in relation to health and education, you can justify a bit more for Scotland but you cannot justify the amount more that Scotland currently gets.

Lord Forsyth of Drumlean: When I was Secretary of State, my officials always told me when I went to negotiate budgets for the Treasury, “Under no circumstances agree to any kind of needs-based assessment because it will cost us £4.5 billion”. I do not know what the number is now. Are we not making a big meal of this needs assessment difficulty, because at the end of the day, both in Wales and in Scotland, the money that comes as a block grant is distributed using a needs-based system? The money goes to health and local authorities using a needs-based system which takes account of demography, sparsity and all the rest. What is the big deal about applying the same principles that you use to dish out the money to determine what the total should be?

Professor Kay: The big deal is that Scotland would get less than it gets at the moment.

Lord Forsyth of Drumlean: Exactly. But if that is the problem, the way to deal with it, is it not, would be some kind of transitional relief that would allow for equilibrium to be established over a period of time?

Professor Kay: That is right, yes.

Professor Lloyd: Just a comment. We have been talking about simplicity and transparency. Any needs-based system can be quite complex, so it may not be simple but it can be transparent.

Q103 Lord Monks: As you were answering that question, I was reflecting on what sort of person might be called upon to lead this independent commission. I have a vision that he or she might make the South African referee look quite popular. The pressures coming from all angles on the particular Solomon who gets chosen for that job will, I fear, make it about the worst job in British public life. My question is in the same general area, and that is the block grant adjustment. Should it reflect the devolved powers of taxation in some way? James Cuthbert has criticised the proposal to index the adjustment to revenues in the rest of the UK because if Scotland has a lower growth rate it would be disadvantaged and it would have limited powers to grow its own economy. What are your views on that particular aspect?

Professor Kay: Given that the Barnett formula is going to survive for at least the immediate future, you have to do something like that, but it is not sufficiently clear what it means or how it works for you to have any confidence that it is a sustainable solution.

Lord Monks: Are there any other observations on that?

Keith Cochrane: I really cannot comment on the specifics of the block grant adjustment mechanism, other than to say that what both Governments should seek to do is establish a clear base line for assessment. Once we have that clear base line, that clear starting point, it is then a matter of understanding the parameters. It goes back to part of the earlier discussion. My own sense is that we could get lost in the mists of time around Barnett. There is going to be a one-off adjustment as a result of the transfer of taxation powers to Scotland, and potentially Wales in due course. Once that is made, and perhaps there need to be some transitional arrangements, the key, starting from that new base line, is how do you adjust it? If we try to treat it and think about it as Barnett, we could just compound the challenges that we have. Let us look at it afresh. Let us say, “This is the base line”. It does not necessarily mean any change in funding, so no one is any different from the day before to the day after, but we then have a clear adjustment mechanism based on the changes or the impact of those changes going forward.

Lord Sharkey: How do you decide on the adjustment mechanism? Do you not need an underlying principle, or at least an objective, to devise any kind of mechanism that has a chance of fairness or stability?

Professor Kay: That is right; it is because there is no principle underlying the Barnett formula that you cannot find a sensible principle for adjusting it going forward.

The Chairman: It is worse than that. There is no underlying principle. It is fairly opaque. Parliamentarians, both north and south of the border, are being asked to vote on new arrangements when there are no details of how it is all going to work. Is that satisfactory in your view?

Professor Kay: I was surprised when Professor Lloyd said that people in Wales were excited by the Barnett formula. It is the first time I have ever heard anyone say that.

The Chairman: There is a complete lack of information in the public domain and for parliamentarians to come to a reasoned decision on whether they should support this legislation or not.

Lord Sharkey: Was there not a principle underlying Barnett in the first place, which was the expectation of convergence? That is a coherent principle, but it seems to me that clearly it has failed. Since no principle has been substituted for that, it is hard to see how you choose one mechanism over another.

Professor Kay: What prevented convergence was the mixture of politics and the slower growth of the Scottish population than the UK population. That is what created the position we are in now.

Lord Forsyth of Drumlean: Guilty as charged.

Q104 Lord Griffiths of Fforestfach: I would like to come on to the “no detriment” principle of the Smith commission, and particularly the second part of it, which is that there should be no detriment as a result of post-devolution policies either by the UK Government or by the devolved Government. Will this ever fly? Is it in any way practical?

Professor Lloyd: The initial adjustment to the block grant following devolution is the easy bit to decide on. It is what happens thereafter, and this is what your question refers to. Going back to the Silk commission and its predecessor, the Holtham commission, the recommendation we made was that the concept of indexed deductions should be embedded. It is important to know in advance, though, how the block grant will be adjusted following devolution of responsibility to reflect the changes. I can see that the whole purpose of "no detriment" is that policies implemented on one side or the other of the border should not adversely influence the other side. I think that most people would accept that something along those lines is necessary. The detail needs to be worked out before anything takes place, not afterwards; that is part of the whole picture. My plea is that it is given thought well in advance.

Lord Griffiths of Fforestfach: What if you had substantial asymmetric shocks on both sides, or you had a change of Government, let us say in England, with a much more radical approach to something or other than the Scottish devolved Government, so we are not talking about something incremental but a major knock-on issue? People have argued that you can apply this principle at a very high level, but I never know how high is high. With smaller changes you can see that it would work, but when you have something more significant it seems to me that it is a real problem.

Professor Kay: I do not even see how you can make it work with small changes. I can see how you could make it work in one or two extreme cases: for example, in the discussion of Northern Ireland corporation tax. If you get people brass-plating their activities in Northern Ireland, you can estimate how much that is and compensate for it. Suppose you reduce health expenditure in England and make people pay for it, with the result that ill people are more inclined to go to Scotland and healthy people are more inclined to go to England. Does anyone really imagine that you are going to pay compensation between the two jurisdictions to reflect that? It just does not seem real to me. Every possible case where you might cite the "no detriment" principle is again going to be a matter of argument. It is an easy and attractive principle to write down but a hopeless one to apply.

Lord Forsyth of Drumlean: We took some evidence from Sir Danny Alexander earlier, and I put to him an example similar to one that was included in your *FT* article, which I thought was excellent, that when we were in government we privatised water in England but we did not do so in Scotland. The result of that was that the Barnett consequences of the money that we spent on water did not go to the Scottish block, and I had to find savings elsewhere. I understood the "no detriment" principle to mean, in this new world, that if something like that happened the English would send a cheque to the Scots to compensate them for the loss of revenue. He said no, it does not work like that at all; that is not how it would work.

What is your understanding of how it would work, because if that is not how it works I do not know what "no detriment" means.

Professor Kay: It ought to work in the way you describe. I do not think that anyone knows how it is going to work.

Lord Forsyth of Drumlean: Is it not absolutely impractical to say to people in England, "You are all going to have to pay for your water because we want to save public expenditure. By the way, we are going to send some money to the Scots, who won't have to pay for their water, to compensate them for the difference"? That seems to me to be difficult.

Professor Kay: This is just the tip of an iceberg, a set of unanswered questions, about how adjustments to the block grant are made once there start to be any material differences in policies between England and Scotland. You can multiply the examples endlessly. Indeed, in the absence of hypothecation between rest of the UK expenditures and rest of the UK taxes, you are going to have the kind of argument that you have just described all the time, and we are not going to have that kind of hypothecation.

Lord Forsyth of Drumlean: While you are having that argument, if you have English votes for English laws, is that not going to create a further difficulty?

Professor Kay: As you know, in the article I said that I could not think of any English law on which there would be an English vote, given that we have this kind of funding formula.

Lord Kerr of Kinlochard: Because any English Act that had expenditure implications only for England would under this deal, the "no detriment" promise, have an implication on transfer to or from Edinburgh.

Professor Kay: Yes.

Lord Kerr of Kinlochard: Also any change to UK revenue-raising powers, even if it only applied to England, would also have expenditure implications, so "no detriment" comes in whichever side of the budget you are talking about. How can it work?

Professor Kay: That is a rhetorical question.

The Chairman: Lord Sharkey.

Q105 Lord Sharkey: Following the Smith commission proposals, what additional borrowing powers should Scotland receive? What principle should determine the size of the permitted additional borrowing?

Keith Cochrane: There is a strong case for allowing the Scottish Parliament access to capital markets, the bond markets. Our submission to the Smith commission proposed that the

Scottish Government have the ability to borrow up to 3% of GDP, perhaps averaged over a year or two previously. There is no science for the 3% other than the eurozone criteria that have been established. My understanding is that that would give Scotland a borrowing limit of around £4.5 billion, available both for opex, and indeed capex. From my perspective, that gives rise to a few benefits. One is that perhaps it helps to smooth out some of the volatility in terms of revenue raising. Secondly, it gives the Scottish Government the ability to have direct exposure to the markets, and accountability in understanding the market reaction to some of their policies is no bad thing. Thirdly, it enables choice to be made about opex and capex, and reduces dependence on Barnett by taking another chunk of revenue out of Barnett and being supported by different means.

Lord Turnbull: You talked about a 3% annual borrowing limit, and then you talked about it being spread over a number of years.

Keith Cochrane: I think that 3% of Scottish GDP is around £150 million per year, or perhaps you could average it over the two prior years. There are a number of variations on that principle.

Lord Turnbull: When it has been running, is there then a debt ceiling?

Keith Cochrane: The reality, as I said earlier, is that that is around £4.5 billion. Let us keep this in context. I am not sure that you need to worry about debt ceilings. UK public debt is £1.5 trillion at this point, so building up £4.5 billion to £5 billion a year, it is going to be a long time before that becomes anything like material in the context. It raises the interesting potential dichotomy in the future—

Lord Turnbull: It may be material to the UK finances, but it could become material to the Scottish Government's finances.

Keith Cochrane: It could, but then that becomes a call for the Scottish Government as to how they manage their financial affairs in terms of ability to repay and fund the interest. One would imagine that if the markets were working effectively, as that debt burden grew, interest costs would go up.

Lord Turnbull: I do not know whether someone was going to ask the obvious next question about bail-out. Should there be a prohibition? Lord Sharkey, were you going to follow that up? I do not want to steal your thunder.

Lord Sharkey: Professor Kay and Professor Lloyd may want to comment.

Professor Kay: It depends on what the objectives of devolution are, once again. Where we are at the moment is that the UK Treasury is absolutely determined to maintain overall control of macro-economic policy, and therefore it will not devolve significant borrowing power. It is a political decision for you in this building to decide whether you want to maintain that objective or not. Personally, I do not have a very strong view on it either way. One thing that is a bad idea is the situation we are in at the moment where the Scottish Government have no real borrowing power but have made quite vigorous use of PFI-type initiatives to do more balance-sheet financing.

Professor Lloyd: The position in Wales is slightly different. Obviously, the area is much smaller. Interestingly, there has not been much exposure to PFI in Wales compared with Scotland. The Silk commission recommended that there should be borrowing powers, and that has been accepted, for the Welsh Government. The only principle I suggest is that the quantum should be related in some way, perhaps not directly in proportion, to the amount of tax-raising powers that the Welsh Government have. The more taxation they can raise for themselves, the higher the borrowing should be. That linkage seems reasonable in terms of quantum. Again, it is really important for empowerment for the Welsh Government that they have some borrowing powers.

Lord Kerr of Kinlochard: Can I assume that nobody thinks it would be desirable or credible to legislate for a no bail-out rule? I see no point in it. It did not work terribly well in the European Union and it seems to me that it would be incredible in the markets that, while the United Kingdom remained a single country, a no bail-out rule would be applied.

Professor Kay: It sort of works in the United States.

Keith Cochrane: There is a difference between explicitly legislating for no bail-out and explicitly guaranteeing the debt. My own sense is that a debt issued by a Scottish Government should not be guaranteed from the United Kingdom. In that sense, they should stand on their own feet. That is a slightly different answer to your question. It comes back to the principles of devolution and what the Smith commission are seeking to do. If the objective is to make the Scottish Government accountable and more responsive to the marketplace, to their sources of revenues, and to take account of those in the spending decisions they make, the ability to get direct exposure to the markets, which over time builds, I accept, a growing pool of debt, is frankly no bad thing.

Lord Griffiths of Fforestfach: You say it is no bad thing, but I well remember 1976 when we had to go to the IMF. Let us assume you get some Government in Scotland and inflation really takes off, and interest rates rise through the roof, and the austerity which is then necessary is very significant. Then you are asked, "Do we just let the debt go?" It would be very hard, if we are part of a United Kingdom, to say that we do not have some moral responsibility to help.

Keith Cochrane: I take that point. Perhaps one way would be to create some sort of cumulative cap that over an extended period of time seeks to address that concern. There is no point in the Scottish Government just issuing debt that is automatically guaranteed by the Westminster Government. It really does not do anything, from my perspective, to enhance their accountability, exposing their decisions to the markets per se.

Professor Kay: While that is true, it does not answer the question of whether a no bail-out rule is credible. The argument that in a United Kingdom it is very difficult to make it credible is hard to disagree with. I mentioned the United States, which seems to me to be at least a partial exception to that. No one is confident that the federal government would bail out California or Illinois, but the United States has a history as a looser federation than we are talking about. It therefore also has a history, even if it was quite a long time ago, of states going bust and defaulting on their debt.

Lord Kerr of Kinlochard: You looked incredulous at my saying that surely this "no detriment" system just cannot work. You thought how naive I was just to realise that now. If you go back in the literature and look at the Smith Commission and what the two Governments said immediately after the Smith Commission, you will find the philosopher's stone. You will find something called the fiscal framework, which is going to be crucial. I keep looking in the current documents for the fiscal framework, say when the Bill goes through the House of Commons, but it does not seem to be there. What do you think is going to be in the fiscal framework? Is it satisfactory to pass this Bill without knowing what is in the fiscal framework, and what would you put in the fiscal framework to try to reduce the problems we are talking about in the working of the system over time?

Professor Kay: It seems to me that this discussion has pointed to what would be the only rational basis, which would be some kind of grants commission, to have something that people have described as a needs-based formula. Saying we have a needs-based formula raises an awful lot of questions that need to be answered about what you mean by assessing needs for these purposes. Having done that, you need an independent commission to implement it and you need transitional arrangements. Something like that is the only structure that stands a chance of being defensible in the long run.

Q106 Lord Forsyth of Drumlean: Do you think that on both sides of the border, ordinary folk, not political anoraks, have a clue about what is involved and what is going on? If you do not think so, what can we do about it? I have a horrible feeling that folk think that all this is going to mean more money, not less money, and more control. Every time I look at it, it seems that it could turn out to be the reverse. That is one thing about public information. Secondly, on information that is available to people who are making policy, or who are commenting on policy like yourselves, do you think we have the information about the nature of the tax base in Scotland, the revenues and the rest, in any degree of certainty or accuracy that would enable us to predict what is likely to happen?

Professor Kay: Do people have much idea? No, although you have the apparent inconsistency that people do not quite realise, on the one hand, that the issue of the formula at the moment is that Scotland gets rather a lot, yet people are also worried about whether Scotland could be viable as an independent country. There is an obvious contradiction between those two kinds of thought, which does not seem to be in a great many people's minds. Could we make it clearer? Only by the kind of mechanisms that we have been describing—having some kind of determination based on a principled structure of how grants should be determined.

Lord Forsyth of Drumlean: On the issue of the reliability of tax and expenditure data on a regional basis, do you think that we have enough information?

Professor Kay: It is not that bad. In most statistical areas, Scotland turns out to look rather like the UK as a whole, although part of the reason is that we are not clear enough about the data. You discover that sometimes the data are 8.5% of the UK figure.

The Chairman: Professor Kay, you said earlier that retaining the Barnett formula was a starting point for contentious argument. We can add to that that we are going into this slightly blind-sided, if I can describe it in that way. You also made the point that any rapid change in the current arrangements would leave Scotland rather worse off, which would politically be probably unacceptable and unattractive. We are in rather an awkward position. You were implying earlier that we are heading towards a crisis point—my word, not yours. Is there a way of resolving this, a transitional arrangement, which can get us to a more sustainable solution, or are you saying, and I would be interested in the view of all of you, that we have to allow this to work its way through, and there will be a crisis and that only in a crisis can the situation be put on a more sustainable and transparent footing?

Professor Kay: We probably are boiling towards a crisis. My worry is that this drifts towards Scottish independence not so much because it is wanted but because it is the only way of resolving the problems that have been created. I am saying that without prejudice to whether I think that would be a good or a bad outcome, but we might drift there because we have not found a mechanism for resolving the problems which were created, in large part, by panicky promises round about the referendum.

Professor Lloyd: I would like to make a comment about gathering information. We felt that there is certainly a need to ensure improved quality of information, both economic and in other areas, in particular comparative information from different parts of the UK. Sometimes, not so much in the economic sphere perhaps, but in others—the health service, for example—information is gathered on a slightly different basis in different places, whereas it is presented as if it were on the same basis. That is really quite dangerous. There is a job to be done there.

Q107 Lord Forsyth of Drumlean: I have a question about information and people knowing what is going on, which is really directed to Keith Cochrane. I notice that Standard Life have moved their domicile, their registration as a company, from Scotland to England. That was reported in the newspapers. Do you have a view from the business community—I am trying not to lead the witness—as to what extent uncertainty about these issues is actually creating either an acceleration or deceleration of business issues, or are people so unaware of what is going on that it is not an issue?

Keith Cochrane: There is underlying concern across the Scottish business community that there remains considerable uncertainty both as to the outcome of the Smith commission settlement and the legislation that is developing now, and more generally the direction of travel of Scotland. Is that translating into real business decisions today not to invest in Scotland, to put it as bluntly as that? I do not think so. It is something at the back of people's minds that they are very conscious of, without necessarily knowing all the detail. I guess the worry is that, if uncertainty compounds upon uncertainty, it starts to be a factor. Where we ourselves have seen it as more of an issue is probably in our ability to attract talent—people—from south of the border to come and work in Scotland, particularly against the backcloth of the potential taxation changes where people are aware of what is happening. They may be aware at a very superficial level of some of the statements that have been made about raising tax rates in Scotland. Against the backcloth of individuals having a choice, do they consciously decide to move? Scotland has very many capable and highly talented people, but, equally, occasionally you want to look in a broader pool and source individuals from elsewhere. That has the potential to be more of a challenge in terms of attracting top talent, as uncertainty impacts on individuals, particularly around the taxation question. Finally, on information, there is a superficial understanding of what is going on, but it is superficial, right across the Scottish population.

For all the complexity, the ideal is that you get the tax changes, because there is an unstoppable momentum in terms of the taxation powers; that train has already left the station. I do not disagree with Professor Kay's comments about some of the challenges that that brings, but against that backcloth, how you change the debate and how you make it real for individuals in Scotland is when the political parties have to start talking about what they are going to do to tax rates. What are the choices they are going to make around raising taxes? Do they transfer that additional income, if additional income is raised, to welfare or to other activities? That is when you make it very real—when you bring it home and that debate takes off. That is why, if we are in a position to have that debate as part of the next Scottish parliamentary elections in May next year, you fundamentally change people's understanding and knowledge, because it becomes a very real issue that starts to impact on people personally.

Professor Kay: Chairman, I think you have been told that I have to give a lecture, so unless you have any further questions for me—

The Chairman: You took the words out of my mouth. That brings this session to an end. Thank you very much indeed for your contributions. It has been very helpful.