OFFICIAL REPORT
AITHISG OIFIGEIL

Finance and Constitution Committee

Wednesday 8 May 2019

Session 5

The Scottish Parliament
Pàrlamaid na h-Alba

Wednesday 8 May 2019

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FINANCE AND CONSTITUTION COMMITTEE
10th Meeting 2019, Session 5

CONVENER

*Bruce Crawford (Stirling) (SNP)

DEPUTY CONVENER

*Adam Tomkins (Glasgow) (Con)

COMMITTEE MEMBERS

*Tom Arthur (Renfrewshire South) (SNP)
*Neil Bibby (West Scotland) (Lab)
*Alexander Burnett (Aberdeenshire West) (Con)
*Willie Coffey (Kilmarnock and Irvine Valley) (SNP)
*Angela Constance (Almond Valley) (SNP)
*Murdo Fraser (Mid Scotland and Fife) (Con)
*Emma Harper (South Scotland) (SNP)
*Patrick Harvie (Glasgow) (Green)
*James Kelly (Glasgow) (Lab)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Derek Mackay (Cabinet Secretary for Finance, Economy and Fair Work)
Iain Pearce (Scottish Government)
Jonathan Sewell (Scottish Government)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Finance and Constitution Committee

Wednesday 8 May 2019

[The Convener opened the meeting at 09:15]

Earnings

The Convener (Bruce Crawford): Good morning and welcome to the 10th meeting in 2019 of the Finance and Constitution Committee. I ask those present to do the usual with their mobiles.

Under agenda item 1, we will take evidence on earnings in Scotland from Derek Mackay, the Cabinet Secretary for Finance, Economy and Fair Work, and from Victoria Beattie, head of the workplace equalities team, and Simon Fuller, deputy director, economic analysis, at the Scottish Government. I warmly welcome our witnesses to the meeting this morning and I invite the cabinet secretary to make an opening statement.

Derek Mackay (Cabinet Secretary for Finance, Economy and Fair Work): Good morning, convener. Recognising that this is an exploratory topic, I am happy to go straight to questions.

The Convener: That is helpful—thank you.

Our adviser has told us that, in 2017 and 2018, average wages grew less quickly in Scotland than they did in other areas of the United Kingdom and that understanding the causes of that relative Scottish earnings slowdown should be an on-going priority for us, given its potential impacts. Are you concerned about the potential impact of that slowdown on the size of your budget? What measures could you implement to respond to the situation? I recognise that any measures that you can take or levers that you might have might not be significant.

Derek Mackay: Yes; we want to increase earnings across the private and public sectors. We have a specific public sector pay policy. As some of the statistical analysis will have shown, over the medium term, the oil and gas downturn will have been one significant factor in the slowdown.

On economic growth, we are making a range of interventions. On my appointment as economy secretary, that included the economic action plan. We are doing more on productivity, innovation and investment, we have set out what we want to do on infrastructure and internationalisation and we are welcoming more investment in research and development.

All that gives us the right approaches to support the enhancement of earnings potential in the public and private sectors. Further work will take place on retraining and upskilling. As the economy transitions—it is clearly transitioning—we need to make the right interventions, to make sure that we focus on quality as well as the quantum.

For reasons that this committee understands better than any other committee, the fiscal framework has an impact on the relative position of earnings in the UK and in Scotland.

The key issue is productivity, which is why we are very focused on that.

The Convener: We held a panel session on the living wage. Some of the noise about what the Scottish Government is doing was positive. However, although we might be ahead in terms of the number of living wage accredited employers, that number is very small in relation to the overall number of businesses. Can we do more in the living wage arena to encourage more employers to be involved?

Derek Mackay: Absolutely. We have launched the fair work action plan in support of the living wage. Of course, employment law is reserved and the setting of the national minimum wage is a matter for the UK Government.

The Scottish Government was the first Government to be accredited with living wage status. Through our procurement and other policies, we have tried to create a culture in which accreditation is the expectation. We cannot necessarily compel employers, but we have tried to encourage accreditation as appropriate; for example, the business pledge has a focus on encouraging the private sector to follow such practice. We also create that culture of expectation through our own employment policies—we pay the living wage and encourage other parts of the public sector to do the same.

By encouraging as many businesses as possible to pay the living wage, more people are paid the living wage in Scotland than in any other part of the UK. That is a good sign, but we want to get that number to 100 per cent; we also want to continue to improve the level of the living wage.

Therefore, there are actions by way of encouragement and there is a culture of expectation. Where we can compel payment of the living wage through our own employment policies, we have been doing that, recognising that that is the minimum that we can do.

On average wages, there is more to do across the composition of employment, but we have certainly been proactive on the living wage and we will continue to look at that. For example, we are reviewing the small business bonus and looking at how businesses supported by the enterprise agencies can further support fair work first. There are a range of interventions.

The Convener: You mentioned productivity and I know that a couple of members want to explore that issue more deeply. James Kelly will begin that discussion.

James Kelly (Glasgow) (Lab): In our last session, we heard that the wage growth issue has been around for some time. For example, median hourly earnings are 1.9 per cent below what they were in 2009. As you said, cabinet secretary, that becomes a concern when it feeds into the fiscal forecasts. If weak wage growth is forecast, that can compromise the budget. As you said, one of the reasons for the wage growth issue is to do with weak productivity. What does the Government see as its main task in increasing productivity? How do you link that to improving wage growth?

Derek Mackay: That is a fair analysis. Over the period of devolution, productivity in Scotland has improved—we have been closing the gap over the period of devolution and there have been further improvements since 2007 specifically. Not every year has seen big leaps in productivity but 2018 was a much stronger year. I am mindful that in eight minutes' time, further productivity statistics will be available for the last quarter, but there has been improvement over 2018.

We recognise that productivity is an issue for output, and that is why the Government has introduced some of the interventions that I mentioned earlier.

The economy is transitioning, so we want to look at the economy of today and the economy of the future, which is more around digitalisation. We recognise that automation is an issue, but there are positives and opportunities as well, in coding, design and digital jobs of the future.

Enhanced productivity can also come from upskilling and focusing on quality in manufacturing as well as on spend on innovation and R and D, which are important for industry. That is why we are supporting the national manufacturing institute for Scotland, expending more on our innovation centres and working with universities. On education and the economy more widely, we support an education system that is clearly focused on skills as well.

The retraining partnership will be important, as many jobs will be changing. That partnership will focus on productivity. We will be working with the Scottish Council for Development and Industry on productivity clubs, because we recognise that a lot of best practice might be found in companies, which can share that best practice with other companies. Sharing good practice in relation to productivity is a key issue. In strengthening the economic strategy, the four strands of infrastructure, internationalisation, inclusive growth and investment will all play a part in enhancing productivity.

In relation to the living wage, what we pay is important and focusing on quality is important. There is an expectation that the childcare sector will pay the living wage and we are encouraging the living wage to be paid and we are trying to improve quality; quality and productivity go hand in hand.

There are a range of actions in the economic action plan that show that we see productivity as a serious issue and want to tackle it. However, the signs are that, over the period of devolution, we have made progress on narrowing the gap between the UK and Scotland, and 2018 was a stronger year.

Oil and gas will have impacted on the productivity figures, but there is now some resurgence, which will feed through to the wider economy.

There will be further information coming on productivity for the most recent quarter, but I think that we have made progress in 2018, so we need to keep that up.

James Kelly: You mentioned technology, which is clearly a big advantage. What are the key sectors in which you see technology improvements boosting productivity? How do you balance those advances in technology with the fact that automation will produce job losses in some areas? You will want to have a policy that counters that with an increase in jobs and opportunities in other areas.

Derek Mackay: That is a good question. We recognise that the economy is transitioning and we already know that there will be a shortage in digital jobs. There are already great employment opportunities in the digital sector but we must make sure that our workforce is trained and has the necessary accreditation and skills to be able to fill those jobs, so that we can attract more of them.

There have been some big, really welcome announcements on jobs—2,500 jobs at Barclays Bank in Glasgow and 400 jobs at KPMG—and there are other financial institutions looking right now at how they invest in Scotland. Naturally, they want assurances that we will have people with the appropriate skills to populate those jobs.

Although industry and manufacturing are changing, there are jobs in design, innovation, coding and digital. Through the city deals, and the investments that they make, we are looking to the industries of now and the future. Edinburgh is a good example of that, with the city deal investing in big data, technology and robotics.

Therefore, although automation is a challenge, with the jobs that it displaces, it is also an opportunity, with the new jobs that it creates. That is why we need to calibrate the enterprise and skills system, to make sure that we create as many jobs as possible.

It will not be lost on the committee that we have record low unemployment, at 3.3 per cent; we are outperforming the rest of the UK, which is on 3.9 per cent. Of course, we want unemployment to be as low as possible; and we want employment to be as high as possible, as well, because beneath those figures, there will be issues of underemployment.

Focusing on quality means investment in manufacturing.

On the question about sectors, we can do more around exports and we have launched the new export strategy. Food and drink is a very successful sector, and whisky is an example of an industry that has really focused on productivity. One of the fastest packaging and bottling lines in the world is at the Shieldhall plant in my constituency, which I visited for its 40th anniversary. It has invested in productivity and has sustained high-quality, high-paid jobs. We want to share good technical expertise in relation to productivity.

All sectors matter to the Scottish economy, but there are real opportunities in life sciences, production and manufacturing. That is why the national manufacturing institute will be so significant for us. That is about the Government working with the private sector and academia to make those leaps in productivity. It is about commercialising the academic outputs that we are investing in and trying to bring all that together through the enterprise and skills system.

James Kelly: You mentioned academic outputs. When I am speaking to businesses, one of the issues that I pick up on is the gap between the information technology skills that graduates come out of the system with and the skills that business and industry actually need. What is the Government doing to bridge that gap?

Derek Mackay: One of the recommendations from the enterprise and skills review was about ensuring that the education system delivers what business and industry actually need. Some of the work will be around having the necessary professional or company-recognised accreditation—in the digital sector, that might be Microsoft accreditation, for example.

A lot of companies in Scotland are doing fantastic work, but they hide their light under a bushel. Partly because of their clients' commercial confidentiality, they do not want to shout about their success, but there is a lot of good work going on in Scotland right now.

Businesses have said that the focus should absolutely be on the skills that are required now and in the future, and digital skills are a good example of that. The Government is ensuring that we have the right partnerships between higher and further education and business and industry to build accrediation and other such considerations into courses.

09:30

Foundation apprenticeships and particularly graduate apprenticeships are important. If a student who is going through the education system is being paid by a company—it might guarantee them a job, too—that is good for the academic institution, good for the student employee and good for the company. In real time, that gives business and industry the skills that they need and ensures that the person is educated. Those involved are not necessarily young—apprenticeship opportunities are open to many, not just to young people.

Graduate apprenticeships give people the necessary qualifications and accreditation and give them pay in their pocket, which is good for retaining people. People come out work ready and have been trained in the academic institution at the same time. Sometimes, businesses tell me that people have become work ready some time after they have gone through an academic course, but many of the interventions and recalibrations of the system, such as graduate apprenticeships, are intended to ensure that people are work ready as they go through their education.

Scotland does well at having a highly educated population—we have more graduates per head than most other nations, which is good. Ensuring that people have the necessary accreditation—accreditation that is professionally recognised or which is what business and industry want—is a helpful development.

It is making a difference to our economy and is partly why some companies are choosing to invest in Scotland now and why Scotland is attracting more big companies to come here—because we have an ecosystem of growth, a talented workforce and ways into education. Some such companies are engaging with colleges and universities on bespoke courses that are right for their sector. That is the right kind of partnership to connect the education system's needs with the needs of business and industry, to give people the best start in employment.

Willie Coffey (Kilmarnock and Irvine Valley) (SNP): I am glad that the cabinet secretary mentioned the digital economy. I do not want to drop us into a Brexit discussion immediately, but the UK Government's stated intention is to leave the digital single market, which could be worth about €400 billion a year throughout the European Union—Scotland's share of that is roughly €4 billion a year. If we are pulled out of that market, what effect will that have on the Scottish economy and particularly the digital economy?

Derek Mackay: It is well appreciated that a no-deal Brexit would be catastrophic for the economy because of its wider economic impacts. The published advice from the chief economist about the impact on the wider economy refers to recession, gross domestic product contraction, business failure, the effect on Scotland's finances and fewer exports. Beneath all that is greater stress for companies because of the challenge of finding available staff and the effect on investment in universities and research programmes.

The panoply of impacts on the economy would be sorely felt, which is why we are trying to avert a no-deal Brexit, although any form of Brexit will have an impact on the economy and individual sectors—we have published information on sectoral impacts, too. Brexit will affect our economy adversely, as opposed to the growth that we would enjoy if Brexit did not happen.

The digital economy will be hit because education and the wider economy will be hit and business and industry will be affected. That is partly why the digital sector is so concerned about Brexit. People in the digital sector are highly mobile, and the impact on freedom of movement will affect employability and the availability of skills, a talented workforce, students and research. For all those reasons, Brexit will have a negative impact on the economy.

The Convener: I recognise the link between the digital single market and productivity, but the session is primarily about pay, so talking in that context would be helpful.

Angela Constance (Almond Valley) (SNP): My questions are about the link between productivity growth and pay.

In our wide-ranging round-table discussion a few weeks ago, Russell Gunson said:

> "we need to focus our productivity policy as much on the everyday parts of the economy as on the growth sectors that the Scottish Government has picked out"—[*Official Report*, *Finance and Constitution Committee*, 24 April 2019; c 12.]

I am interested to hear the cabinet secretary's response to that view. What does he consider to be the "everyday parts of the economy", and how does the Government demonstrate support for those? It is easier to demonstrate support and inputs for high-growth sectors; it would be good to have a better understanding of how the Scottish Government is using its levers to support the everyday parts of the economy.

Derek Mackay: The badge that I am wearing today is about the national performance framework, which is underpinned by the United Nations sustainable development goals. It tries to calibrate all the Government's actions to focus on our purpose, which is a flourishing society that realises the opportunities that we have.

With regard to the day-to-day economy, a way to raise quality is through what is paid. What we pay directly for day-to-day services is important for paying the living wage and trying to support a public sector pay policy that properly remunerates staff. That can raise quality, because investing in skills is the right thing to do, as well as making sure that good practice is shared.

An example of big new commitments is our childcare policy, which sets out that we want all staff to be paid the living wage. We have made the resources available to do that. In day-to-day spending, the Government's biggest spend is on the payment of salaries and the remuneration of our staff, and we want that to reflect quality, investment and good practice.

Right across Government, we focus on good practice, productivity and proper remuneration for day-to-day services. I have focused on growth opportunities because they have great potential to create high-quality jobs, partly to replace those that might no longer be there. An example of the day-to-day economy in the private sector was the announcement that Michelin would be leaving Scotland. It is a good example because there will no longer be any industrial manufacturing at the Dundee site, and that is why we have worked proactively with the company on opportunities for employment now and into the future.

We asked where the entrepreneurship is, how we can support the transition to the circular and low-carbon economy, and how we can create jobs through our investments and partnership approach. Michelin agreed to stay to help us with that exercise because of our vision for the country—the national performance framework. We set out our vision for the country, the investments that we are willing to make and the outcomes that we are focused on, which cut across portfolios, to make sure that we make the right investment for the gender pay gap, fair work first and what our enterprise companies are doing to create the right culture to approach those, whether in the businesses or services of the day or the opportunities of the future.

Angela Constance: I have a few more points, particularly on how to improve our productivity in the service sector. I am thinking about the care sector, whether for older people or childcare, which the cabinet secretary has mentioned. Digital services is an enabling sector as well as a sector that upskills staff in its own right. There is something quite distinct about productivity, and what improving productivity means, in people-orientated services, which is not the same as improving productivity in a big manufacturing sector. It means something different and has to be measured differently, and it would be good to understand more about that, particularly as the Government has made a clear commitment to reducing the gender pay gap, and the care sector predominantly employs women.

The Convener: That theme came through strongly in our evidence session, cabinet secretary, particularly with regard to the care sector. As Angela Constance has described, it has been a challenge to increase and drive productivity at the same time as finding and matching the living wage elements, particularly in the third sector element of the care sector.

Derek Mackay: The health secretary or the communities secretary would be better placed to go into the forensic detail of that. As to the decisions that I can make as finance secretary, an area where interventions can make a difference is telecare. The appropriate use of digital technology can enhance care, and that will affect staff.

Arguably, the challenge that you describe comes up in finance when the third sector is under pressure to drive efficiency, while at the same time—because we want quality, too—paying the living wage, all with the same contracts and money.

There is health and social care integration, so it is about ensuring that the money is in the system and that resources are specifically identified in local government for payment of the living wage in childcare and social care, for example. It is also important that the uplift to pay for that follows through to the third sector, because that sector needs to be resourced to pay for that quality. The question of how we ensure that the resources are there is a fair one.

That takes us back to the debate on ring fencing that this committee has often had. Should we ring fence resources locally for such a cause? Many third sector organisations ask the Government to ring fence resources so that they are guaranteed to receive those resources. Local government resists ring fencing because it prefers the general payment. We support the agenda, but there is a question about how much we should ring fence when we have clearly identified the resource to achieve a policy outcome such as payment of the living wage in the social care sector.

The Convener: Tom Arthur, I know that you want in, but that would mean that we have had quite a number of Scottish National Party voices in a row.

Derek Mackay: That is not necessarily a bad thing.

The Convener: I need to try to keep a balance. I will let Tom Arthur ask a quick supplementary question.

Tom Arthur (Renfrewshire South) (SNP): Cabinet secretary, you talked about the jobs of the future. The First Minister recently declared a climate emergency, which will precipitate a review of all policies across government. Clearly, our first priority is to meet the climate targets by 2045. That will generate a range of areas for innovation and entrepreneurship, not only in policy but in ecology, rewilding, conservation, and, of course, green energy. Although Scotland cannot solve the climate crisis by itself, it can be a pioneer. It can develop and innovate, and export those developments and innovations across the world. Meeting the environmental challenge also presents economic opportunities. How can we capitalise on that in Scotland? In what way can we innovate and develop technologies that will help us to meet our climate change goals while also capitalising economically?

Derek Mackay: The environment secretary will return to Parliament with more to say abut the Committee on Climate Change report and the need to look at our policies and respond to even more ambitious climate change targets. Scotland has a good track record in reducing emissions and we have the most ambitious climate targets in the world. That requires us to look at our policies and our actions.

However, there is also economic opportunity in those policies. I just gave the example of Michelin in Dundee not continuing to manufacture tyres in Scotland. However, when we expressed what we wanted to do around the circular economy, low-carbon transport and entrepreneurship, Michelin decided to continue its presence in Scotland.

I absolutely agree with Mr Arthur that we should seize the economic opportunities of the agenda, which is why we have been investing directly in policies that will make a difference to carbon emission reductions and in future opportunities such as renewables. Last Thursday, I convened a summit with many companies and stakeholders interested in renewables, particularly offshore renewables. There is a view that, although we have been encouraging and consenting to renewables, and enhancing our capacity in the renewables sector, we have not had the onshore industrial jobs that should have come along with that. Although the UK Government has shared that ambition, we have not seen the jobs that we would like to have seen.

We are looking at how we can use our levers to encourage companies to invest in supply chain and industrial jobs in Scotland that match the renewables capacity that we are delivering. That is a good example of ambitious climate change targets going hand in hand with the creation of jobs and employment and economic opportunities.

On the wider issue of our response to the Committee on Climate Change, the Cabinet Secretary for Environment, Climate Change and Land Reform will address Parliament on that shortly.

09:45

Patrick Harvie (Glasgow) (Green): When you announced the public sector pay policy in December, you said that it

"continues the journey of restoration of public sector pay."—[*Official Report*, 12 December 2018; c 35.]

How far will we get on that journey and how quickly will we get there?

Derek Mackay: I cannot set out future budgets or what percentage increase there might be in future budgets, but we have departed from the 1 per cent pay cap. There is divergence between UK Government policy and Scottish Government policy. If we had gone much further on an uplift in pay, that would probably have impacted on head count. We have tried to retain as many people as possible. While protecting the head count, we wanted to give workers in the public sector as fair a level of remuneration as possible within the bounds of affordability.

We have also had a policy of no compulsory redundancies and have targeted low pay through payment of the living wage and the cash underpin. Significantly, we have maintained progression. That sometimes gets lost when people look at the headline figure of a pay increase, but progression is important to those who benefit from incremental increases in their pay.

We have suspended bonuses. The UK Government continues to pay bonuses, but the Scottish Government no longer does that as a matter of course in its public sector pay policy. There are further flexibilities that allow employers in the public sector to target inequalities and equalities issues. There has been a departure from UK Government policy. We have tried to respond to issues around the remuneration of our staff. For the past two years, the public sector pay policy has targeted a higher uplift for people who are paid less, with those who earn less than £36,500 receiving a 3 per cent increase and those who earn more than that receiving a 2 per cent increase. There is a cap at the top, too.

As far as the journey of restoration of public sector pay is concerned, we have moved away from the 1 per cent pay cap. We have tried to increase the uplift within the bounds of affordability so that we have not had to reduce the head count. It has been a careful balancing act. We have been mindful of the inflationary position. Given the situation with the consumer prices index and the retail prices index, many people will have had an above-inflation increase when all those factors are considered together.

The journey of restoration is about fair remuneration for workers in the public sector, but the percentage by which we can increase people's pay will depend on the budgets at the time and the decisions that we make about head count.

Patrick Harvie: I accept completely that there has been a departure from UK Government policy. That is welcome. I am questioning whether the phrase,

"journey of restoration of public sector pay",

is strictly accurate. It would be wrong to give people who work in the public sector false expectations. Do you accept that public sector pay in Scotland remains lower than it was, in real terms, 10 years ago?

Derek Mackay: Yes. That is a consequence of the recession and UK Government austerity. We want to go further, but I do not want to make people compulsorily redundant. There has been a trade-off in order to maintain head count and not to make people redundant. We have been employing more people while there has been pay restraint. That is well understood. There has been pay restraint in the private sector, too, but we have been trying to protect the workforce in the public sector.

The journey of restoration involves us departing from the 1 per cent pay cap and looking at inflation when we make decisions on public sector pay policy. As I said, for the past two years, there has been a differential, with increases of 3 per cent and 2 per cent—those increases are, of course, more than 1 per cent. Within that, there are sectoral bargaining arrangements. Different categories of workers have had different pay awards. Because of the timing and character of the negotiations, different members of staff will have received different pay awards.

Our overall pay policy has departed from the pay cap, which was in place because of the restraint that was necessary at the time.

Patrick Harvie: The balance that you have described between head count and above-inflation pay settlements was debated throughout that decade and more. When your predecessor, John Swinney, was trying to figure out how to respond to the economic crisis and its impact on Scottish public finances, he brought all the political parties together. At that point, there was consensus that we did not want to see lots of redundancies in the public sector and that pay restraint was, unfortunately, something that people would live with for a time.

We have now moved beyond that to the point at which the loss of public sector pay has become intolerable and unacceptable. The fact that some unions, such as teaching unions, have had to work so hard to get the beginnings of restoration in the value of pay shows that. Do you accept that, if the phrase

"journey of restoration of public sector pay"

is going to accurately describe to people who work in the public sector what they can expect, it has to mean a sustained period of above-inflation pay increases across the board, not just for particular sectors?

Derek Mackay: I do not want to attach a definition to the phrase, but I understand the sentiment of your question. We want remuneration that is fair and affordable and that protects head count. It could be argued that the approach could be totally different, with fewer people who we pay much more. We have taken the balance, when executing the Government's responsibilities, of properly remunerating our staff and recognising issues of low pay. It is well recognised—because of our efforts around low pay generally and with regard to the pay differential and capping increases at the top—that a range of interventions have given us a much fairer pay policy. I understand the sentiment of your question and do not wish to attach a definition to the phrase, other than working through the pay agreements that we have made with our staff and that we will continue to do in the light of the financial circumstances that we face. We enjoy relatively good relations with the trade unions with which we engage on pay, and I will continue to take that approach.

Patrick Harvie: My final question is about the discussion in our recent round-table session on this topic about the indirect effect of the public sector pay policy—not just the Scottish Government's but that of local government as well—on wider earnings in Scotland and the impact on the private sector? There was discussion about whether the Government or the more general public sector have ways of maximising the impact of public pay on the rest of the economy, particularly given that some sectors in which poverty pay is most severe are where procurement and suchlike are less relevant, such as retail or hospitality. Are there things that the Government can do to maximise the impact of public sector pay policy on the wider economy?

Derek Mackay: That is a fair question. I am looking at the evidence before me, and I will be frank that there is an issue about how much public sector pay has an impact on what the private sector pays, because there is competition for people. Low unemployment is good—I am sure that we all agree on that—but there is an issue about the availability of people and skills, and what we pay through public sector pay policy will have an indirect impact on private sector pay policy. The culture of expectation or the raising of quality around the living wage is significant.

Our efforts, whether through accreditation or campaigning for payment of the living wage, is probably why more people are paid the living wage in Scotland than in any other part of the UK. That is significant in light of the composition of the rest of the UK economy, especially the stratification and composition of the City of London economy. The practices that we engage in and our public sector pay policy have an impact on the private sector, including specifically on rates of pay and uplift. We have tried to show leadership in our public sector pay policy through how we tackle equalities issues and low pay and also how we have tried to ensure employment through our policy of no compulsory redundancies.

Murdo Fraser (Mid Scotland and Fife) (Con): My question is also about public sector pay policy. We have recently seen different sectoral agreements, which you acknowledged a few moments ago, and an example is the one for teachers, who have had quite a generous settlement, which I think was 9 plus 3 per cent—Mrs Fraser is a teacher so, for the avoidance of doubt, I am not complaining about that. However, at the same time, further education college lecturers, who would regard themselves as providing a very similar service, have been taking industrial action on the pay settlement on offer to them. There is a disparity. Do you really have a public sector pay policy, or are you just making it up as you go along?

Derek Mackay: There is an established public sector pay policy, which acts as a guide. Each trade union, sector and segment of staff is entitled to engage with the relevant employer, part of Government or part of the public sector as appropriate, so there can be departure from the public sector pay policy.

The pay policy is a guide. It is progressive, fair and affordable. Some parts of the public sector will have adhered more closely to it; because of the nature of negotiations, other parts will have a different arrangement. I very much see the public sector pay policy as a benchmark. I set it out in the budget, as I have done every year, but trade unions and employees still have the right to negotiate with their employer to depart from the policy.

I expect public sector employers to deliver all the measures to address low pay, equalities and proper remuneration. Many look to the policy as a guide, but it is not the final say on pay.

Murdo Fraser: You seem to be saying that sectors with better negotiators can get better deals and therefore break or at least push the boundaries of your policy. Do you appreciate the frustration currently felt by, for example, further education college lecturers? They are not being offered a deal anything like as generous as the one that has just been given to teachers.

Derek Mackay: The language that Murdo Fraser used was not at all the language that I used. Pay negotiations are undertaken based on an organisation's history and circumstances, which may include issues to do with service delivery and transformation. The deal that was reached on teachers' pay was in recognition of education as a Government priority and the transformation that is going on in that sector, which includes issues to do with the empowerment of teachers and skills. There was a lot in those negotiations.

Each cabinet secretary leads on pay in their own portfolio and looks at the relevant issues in order to arrive at a conclusion. As I said, the public sector pay policy is a guide, and each category and segment of staff is entitled to negotiate, and that is what has been happening.

Different pay awards come down to the negotiations at the time, which take into account the information and the pay claim that is put forward by the representatives of the employees. I say again that the public sector pay policy is a very strong guide, and it sets out the Government's position.

Murdo Fraser: That sounds more like a muddle than a policy, but thank you for answering my questions.

The Convener: And thank you for your comment, Murdo.

Emma Harper (South Scotland) (SNP): I am interested in wages in rural areas. My region is one of the lowest paid in Scotland; some salaries there are £2 an hour lower than the average hourly wage. The first thing that came up when I googled "rural wages" was farmers and agriculture. However, there are more than just farmers and agricultural workers in rural Scotland, including one-woman and one-man microbusinesses and small businesses. I am interested in hearing about the challenges relating to the cost of living in rural areas. Transport is an issue, too. Citizens Advice Scotland has done food pricing comparisons across Dumfries and Galloway, which show massive differences in the price of identical baskets of groceries from the main supermarkets. What can be done and what is being done to support rural wages and growth?

Derek Mackay: Fergus Ewing leads on the rural economy. The National Council of Rural Advisers has given the Cabinet recommendations, many of which are to do with the vibrancy of rural Scotland and its ability to realise the available opportunities through economic growth, entrepreneurship and building the infrastructure that can unlock the potential of rural areas.

I know that the point was made about farmers. One reason for ensuring that loan arrangements were in place was so that farmers who were receiving common agricultural policy payments were able to benefit from even earlier payment through the loan scheme. We recognise that what farmers contribute to the economy runs right through the supply chain, so ensuring that those loan payments and then the CAP payments were in place was good for the rural economy, representing about £0.5 billion of investment in the rural economy.

10:00

The enterprise agencies have been working in rural areas, whether that is HIE or Scottish Enterprise, which currently operates in the south of Scotland. In the south of Scotland, of course, we will have the new south of Scotland enterprise body, which will invest in sustainable employment opportunities.

There are other, wider investments in the rural economy that will make a difference in terms of infrastructure and education. The public sector pay policy is supporting public sector pay in rural areas, where it can have a disproportionately positive impact.

Other tax levers such as the small business bonus have helped small towns and villages to survive the last recession. There have been some difficult times for our town and village centres. Other tax support has encouraged those entrepreneurial smaller businesses in rural areas that benefit, for example, from the small business bonus.

A range of interventions have supported rural communities and there is more that we can do in that regard. That is why we are engaging with the National Council of Rural Advisers.

Emma Harper: I found it difficult to find out the number of living wage employers in Dumfries and Galloway; 20 are registered, but I am sure that there are more than 20. What can we do to encourage living wage employers to register as such so that Dumfries and Galloway could perhaps not be seen as having the lowest number of living wage employers?

Derek Mackay: There are probably many businesses in Scotland that fulfil all the criteria for Scotland's business pledge but do not seek the accreditation to get the credit for doing that. The same goes for the living wage. Not every employer that pays the living wage is seeking living wage accreditation. I will give further thought to how we might be able to enhance the recording and reporting of employers that are paying the living wage. However, it might be largely about encouraging the private sector to showcase companies that are delivering the living wage and might want to get accreditation for doing so. I will give further thought to how we could capture that figure more fully.

Neil Bibby (West Scotland) (Lab): We have just discussed the role of trade unions in negotiating different settlements in different sectors. What role can trade unions play in driving economic policy and productivity and wage growth? For example, the Council of Economic Advisers, which I presume is one of the main advisory bodies to the Government on these issues, does not have any representation from the trade union movement. If we are serious about wage growth and productivity growth, should we not have a meaningful partnership at the highest level of Government between industry and labour to drive this agenda forward?

Derek Mackay: I understand the question that Neil Bibby is asking about representation but the trade unions have direct access to Government through the range of meetings that we have with them. We have regular meetings with the Scottish Trades Union Congress. The cabinet secretaries regularly meet the trade unions within their portfolios. I regularly meet civil service trade unions and, alongside the First Minister, I regularly meet the STUC on an issue-by-issue basis, so members should not think for a minute that, because there is not a designated trade union representative on the Council of Economic Advisers, trade unions are not engaging with our economic policy and advice, because they are, whether that is engaging on pay, engaging on the economic strategy or engaging directly with the highest level of the Scottish Government.

We have biannual arrangements and trade unions have regular meetings with cabinet secretaries. There are arrangements for the trade unions to meet the First Minister and the cabinet secretaries as appropriate so that they can feed in regularly to our policies.

Neil Bibby: I appreciate what you are saying, but you are having meetings with the Council of Economic Advisers separately from your meetings with the trade unions. Do we not need a proper partnership between Government, trade unions and labour, and industry and economic advisers to drive forward the wage growth and economic growth agenda? I hear what you are saying about engagement, but do we not need to get them all in the same room at the same time to drive the agenda forward rather than you meeting people on different occasions to discuss different things?

Derek Mackay: I conceded that I understand the rationale behind the question, but what is probably more important than who is in which meeting is whether we engage with the trade unions, to which the answer is yes. Do we say that it is a good thing for employers to engage with trade unions? Yes—we say that in the fair work nation policies and the fair work agenda, which the trade unions whole-heartedly welcomed. We engage with trade unions in many forums; they have shaped and contributed to our economic policy in many ways.

I understand the request for representation, but I am not aware that the STUC has made such a request. There are well-established arrangements for engaging with Scotland's trade unions, which have led to a good relationship that is different from the UK Government's relationship with trade unions. In the Scottish Government's relationship with trade unions, we have channels of communication and appropriate forums to discuss matters that are of interest to employees and the wider economic strategy. That has been satisfactory.

Even more important than meetings are our actions, through which we have shown that we can take the trade unions' views on board—not least in our employment policies, in as much as employment law is devolved to Scotland; in our economic strategy; in the fair work agenda and the fair work convention; and in our wider policies.

The Convener: We need to discuss the gender pay gap, which came up in the round-table discussion. We had evidence that the gap fell reasonably quickly until about 2011 but has closed more slowly since then. What levers for action are available to the Scottish Government to address the issue?

Derek Mackay: Many of the legislative levers lie in Westminster, but our policy actions include the gender action plan to address the gap in employment, although we recognise that progress has been made and that we have narrowed the gap. On international women's day, 8 March, we published "A Fairer Scotland for Women: Gender Pay Gap Action Plan", which covers the range of cross-Government approaches that we are taking to tackle the inequality that women face in the labour market. We are also tackling other forms of discrimination and inequality, but I can revisit the plan and present to the committee the detailed actions that we have outlined, if it wants me to. Jamie Hepburn is the minister who leads on the subject and who is tasked with seeing through the action plan.

The Convener: It would be useful to get further information from the Government—whether it is from you or Jamie Hepburn—on exactly what it is doing, so that our consideration of the matter is as full as possible.

Derek Mackay: Sure.

The Convener: My colleagues have no more questions, so I thank the cabinet secretary for his contribution to the discussion, the other witnesses for their time and my committee members for their questions.

I suspend the meeting to allow a changeover of witnesses.

10:08

Meeting suspended.

10:11

On resuming—

Scottish VAT Assignment

The Convener: Our next item is to take evidence on Scottish VAT assignment. We are joined by Derek Mackay, the Cabinet Secretary for Finance, Economy and Fair Work; Jonathan Sewell, who is the head of the Scottish Government's income tax and tax strategy unit; and Iain Pearce, who is an economic adviser to the Scottish Government.

I welcome our witnesses to the meeting and invite the cabinet secretary to make an opening statement, if he so wishes.

Derek Mackay: Thank you, convener. I am mindful that the committee is exploring the Scottish VAT assignment, and is considering the evidence, as we continue to work it through with the UK Government. Officials are doing their best to reach a point at which we are confident about the methodology.

I should say, in that regard, that although discussions with the UK Government are on-going—I have recently raised the issue with the Chief Secretary to the Treasury—there are a lot of issues around volatility, and there are questions around Brexit and the margin of error that we are dealing with. For example, we will never have an outturn statement, so the figures are based on estimates. I have raised my concerns with the Chief Secretary to the Treasury because, in order to continue, we need the sign-off of the joint exchequer committee and the agreement of the UK Government and the Scottish Government.

As we work through those issues, I am becoming increasingly minded to postpone VAT assignment until VAT powers can be further discussed at the time of the fiscal framework review. That would give both Governments time to assess the robustness of the model and to understand the impact of European Union exit.

I am happy to explore with the committee the reasons for my concern about what VAT assignment might do to the Scottish budget.

The Convener: It is a substantial move to say that you are considering postponing VAT assignment. However, we still have to go through the process today of ensuring that we understand the dynamics behind your decision—if that is the decision that you finally come to—and the challenges that have led you to that position. In our evidence taking this morning, we should be as robust as we can be to help you to come to a conclusion.

As you mentioned, one of the major challenges in assignment of VAT is that, unlike for other taxes, there will never be outturn data. As a result, assigned Scottish VAT will need to be estimated, which—as you said—introduces another layer of volatility. To what extent could that volatility be mitigated when VAT is finally assigned? Will you explain how that volatility is driving your thinking?

10:15

Derek Mackay: One of my concerns is to do with the fact that VAT assignment is based on survey data and estimates. We will never have outturn data; we will always be comparing one set of estimates with another set of estimates. Unlike what happens with income tax, there will be no reconciliation. The margin of error for both sets of estimates is such that we could be in a positive or a negative situation.

We will not have certainty. If we had to take money out of the budget or use our borrowing powers or reserves because there was less revenue, that would have a financial impact. I am concerned about the accuracy of the assignation approach, given that we are talking about almost £6 billion of revenue. There is a lack of certainty about its accuracy.

As far as the timescale for a resolution of the problem is concerned, we are in a transition period. If we had more time, we could look at the data, the surveys and the estimates. We would have more information to go on. We do not have that at the moment.

On top of the uncertainty, we face the potential impact of Brexit, which would hit the economy, consumption and VAT receipts. We do not know whether the impact on Scotland would be disproportionate. The lack of data is an issue, and because we are in a period of uncertainty, there is a risk that I am not convinced we should be carrying. Assignation is different from having a power on VAT: we cannot push and pull levers to make a difference on VAT income. I am concerned, given the lack of policy levers, about the level of risk and how we would address any negative impact through the block-grant adjustment, with which all members are familiar.

We want the relevant power to be devolved. Assignation is not a devolution of power, and it carries a disproportionate risk because of uncertainty and lack of data. Once we have boosted the data samples, we will have more data. We can discuss the merits of having a power, rather than assignation, more fully in the review of the fiscal framework, when we will have more data that will allow us to make an informed judgment. I have expressed that position to the Chief Secretary to the Treasury.

The Convener: In effect, you are saying that the modelling will need to go on for longer so that you can find out whether the risks can be mitigated and so that you can see what the trends and flows might be.

Derek Mackay: Absolutely. Although assignation would still be based on survey data, at least we would have assessment over a period of time. At the moment, we face uncertainty with Brexit, which could have an impact on the economy. Given that we face volatility, added uncertainty and concerns about the level of accuracy of the assignation process, it does not feel as though we are in a position to sign off the proposal.

Adam Tomkins (Glasgow) (Con): The issue is worth exploring in some detail, because we are talking about a lot of things at once. I would like to parse the issue and separate out the concerns. To what extent is your current position—wishing to postpone or delay assignation—associated with Brexit uncertainty? Would that have been the case regardless of Brexit?

I would like to put Brexit to one side for a moment. Notwithstanding Brexit, as I understand it—correct me if I am wrong—there can never be outturn data, so there can never be a reconciliation process. Was assignation therefore doomed to fail from the beginning?

Derek Mackay: It has been a difficult situation, because we have only ever been talking about assignation, and not devolution of the relevant power. Many people perceive assignation as devolution to Scotland of a power that will put Scotland in control of VAT. That is not the case. Assignation was always going to be challenging, and for it to proceed we need to have confidence in the accuracy of the estimates and their ability to truly reflect what is going on in the Scottish economy—

Adam Tomkins: Indeed—I am sorry to interrupt—but is that possible? We all agree that we want confidence in the estimates. My question is whether that is possible. You and your officials, and the UK Government and its officials, have spent two years or more working on the methodology to try to nail down estimates so that they are not just guesswork. Notwithstanding Brexit uncertainty—I will come to that in a second—is that doable?

Derek Mackay: Our agreeing to boost the data does not address the issue of accuracy. I have two very well-educated officials here who might offer a view on whether we can fix the situation with even more data, but I fear that we cannot. I also fear that because we are talking about survey on survey and estimate on estimate, the accuracy issue is difficult to overcome.

Politicians and Parliament—this is about the Parliament's powers; it is not just about the Government—make a decision on the level of risk that we wish to carry, and the level of risk that has been identified has not been overcome, even with boosted data, with the best will in the world and with the co-operation of civil servants. The answer is no—we have not found a way to address the risk issue, which is compounded by Brexit uncertainty.

Adam Tomkins: To be absolutely clear, are you saying that the position is that the risks that are associated with assignment of VAT are so uncertain—because we are talking only about estimates and survey data, and there is no outturn data—that assignment could not be done to the satisfaction of the Scottish Government, irrespective of Brexit?

Derek Mackay: What we signed up to in the Smith agreement, as I understand it, is that there must be joint signing-off of assignment. We have not yet identified a system that gives us confidence in the accuracy of the assignment; civil servants have not yet identified a system that can deliver that level of accuracy. That is the position.

Of course, we still want to take on the power, while recognising that assignation is not a power. As things stand, the level of risk is such that we are not in a position to sign off.

Adam Tomkins: The Smith commission unanimously recommended that there be no devolution of powers with regard to VAT rates and exemptions because that would be illegal—it would be contrary to European law. As I understand it, European law prohibits there being more than one rate of consumption sales or value added tax in a member state. Just to be clear, it is not that the United Kingdom Government is saying, "No—we are not going to devolve those powers"; it is that European Union law, by which we continue to be bound, makes that illegal. Is that a correct analysis?

Derek Mackay: Yes, that was correct at the time.

Adam Tomkins: So, the Scottish Government's position is that one of the advantages of Brexit is that it becomes possible to think about devolution of VAT, rather than mere assignment of VAT. Devolution of VAT is possible only if the United Kingdom leaves the European Union.

Derek Mackay: You are, at least, accurate in the proposition that you are putting forward, but it is not a compelling reason for the Scottish Government to support Brexit. It would not change my vote to remain in the European Union.

It is true, as you said, that the UK Government has choices—or might well have choices, if there were to be a different legal position. It could devolve the power if it so wished, which it could not have done under the previous arrangements. That is accurate, but—as I said—the position is not in itself a good reason to support Brexit.

Adam Tomkins: Indeed. This will be my final question, for the time being. Earlier in your remarks, you said that Brexit uncertainty might have an impact on consumption and that it might have a disproportionate impact have an adverse effect on the revenue stream that would accrue to the Scottish Government under any methodology for calculating VAT assignment. What evidence supports the fear that a Brexit impact on consumption would be disproportionate in Scotland?

Derek Mackay: That is to do with the nature of the VAT that is paid in Scotland. One of the officials might want to offer a view.

Iain Pearce (Scottish Government): There are two aspects to Brexit and VAT. First, there is the question of the disproportionate impact on Scotland. As members know, the majority of VAT is paid by the household sector. Based on, for example, the Scottish consumer sentiment indicator, which is published by the Scottish Government, there appears to be a larger impact on household confidence in Scotland, relative to the rest of the UK, and it appears to be associated with Brexit. There seems to have been a larger effect on Scottish households than on those in rest of the UK.

A second question around Brexit uncertainty and VAT is about the fact that VAT is a harmonised EU-wide tax, to a degree. Therefore, the collection of VAT and its paperwork systems are designed in such a way that they do not distinguish between import VAT from the EU and that for the rest of the world. At the moment, as far as I am aware, new paperwork to collect VAT is not in place; that will depend on how we leave the EU. There are risks about how collection of VAT would happen post-EU, which means that 2019-20 would become very uncertain as a base year.

Adam Tomkins: I am still not sure that I understand how the impact of Brexit would be disproportionate in Scotland, compared with the rest of the United Kingdom, which is the issue.

Iain Pearce: Household spending is one of the largest components that drives VAT and the economy in general. If the effect of Brexit on household confidence is larger in Scotland—

Adam Tomkins: Why would it be?

Iain Pearce: Households in Scotland have a slightly different preference on Brexit. They voted slightly differently from households in the rest of the UK in the referendum, so they might be more risk averse in relation to the impact that Brexit could have on their personal finances, which would lead them to save more and spend less. There are a number of channels—

Adam Tomkins: Hang on. Would you therefore expect to see the same effect in London, which also voted heavily to remain? Are you seriously suggesting that the parts of the United Kingdom that voted to remain will lower their consumption after Brexit, compared with parts of the United Kingdom that voted to leave? Is that the Scottish Government's position?

Iain Pearce: That is not the Scottish Government's position. Evidence in the household survey data suggests that householders have already changed their behaviour in respect of how they respond to what they perceive as future risks to their incomes. They might change their spending patterns depending on how they view future risks to incomes. On average, Scottish households have a discernibly different approach to future risks from households in the rest of the UK. That approach to risk could, therefore, crystallise in different spending patterns in the future.

Derek Mackay: Convener, I can return to that issue, to be helpful. It is a fair question. Our concern is that uncertainty will be put upon uncertainty. It is a matter of accuracy while being about to engage in a fiscal system and fiscal change at a point of expected turbulence—if there is a Brexit. The economic consensus is that there would be an impact on various sectors and areas and, we would expect, on patterns of consumption. Because VAT is a consumption tax, there would be an impact.

There is also the potential difference between the two estimates. As we have discussed at great length, because of the different operations of the Office for Budget Responsibility and the Scottish Fiscal Commission, there are issues about the different analyses that will drive the number to which we would be beholden.

The issue is the level of risk. What is unknown is the potential divergence between the economies in Scotland and England in terms of consumption and VAT, and interpretation of that. There is uncertainty piled on uncertainty, so to make the shift at a point of such volatility feels ill-advised.

That said, who knows what the circumstances of Brexit will be or the outcome over the next few weeks? My point is that it is in our interests to have more time to collect more data and to do more comparative analysis. We could then see what the divergence is and make a decision on that basis, which would be better than what feels like going in blindfolded.

James Kelly: Cabinet secretary, you correctly say that, in order to have confidence in the VAT assignment process, you need to have estimates that are accurate and robust and in which you have confidence. It has been said that 70 per cent of VAT relates to household spending. How confident are you about the data sources in the current model?

10:30

Derek Mackay: That is my point—I am not hugely confident. We have gone as far as we can and even boosting the sample data does not give us numbers that fill me with confidence or make me feel that they absolutely truly reflect the state of the economy and the levels of VAT being paid in Scotland.

Bearing in mind that this is a £6 billion assignation, if the margin of error is tens of millions of pounds or even hundreds of millions of pounds, that is a risk. Fundamentally, we would have to pay for that through the budget, and the level of risk—the margin of error—is such that it could have a material impact on the resources that we have available.

I am happy for the officials to say more about the data sets, but I am not filled with confidence that they give us what we need to justify the level of risk that we are carrying.

Jonathan Sewell (Scottish Government): It is also worth reflecting on the point that the volatility created by the data sources and surveys working together is not a risk that we should face. There is a performance risk around volatility, which goes with all tax. That risk is managed within the levers that we have. However, the way that the surveys work together—even if there can be confidence with some of the surveys—creates additional uncertainty that to us does not appear to be a robust or appropriate way to manage the public finances.

James Kelly: With the methodology as it stands, can you express a level of error or a level of confidence in the calculation that has been made? I am not asking you to state that level of error, but does the methodology contain that?

Iain Pearce: We cannot state that at the moment. It is being looked into and we intend to come up with that number, which is obviously important. We do not have it at the moment, because a large number of components go into the model, not just the household survey, and each of those has an associated individual uncertainty.

Although we might know the associated individual uncertainty, we are looking at different methods for adding them all together. That said, broadly, numbers that are already in the public domain suggest that an uncertainty level of around 2 per cent is quite standard for a household survey, so that is the sort of ballpark figure that you might expect any survey base measure to provide.

James Kelly: As it stands, you do not have an overall figure on what the level of error might be, plus or minus.

Iain Pearce: Not at the moment.

James Kelly: What would be the position on VAT-exempt businesses?

The Convener: Before we move on to that question, I want to explore the issue of confidence intervals, on which our adviser and the Scottish Parliament information centre have provided information. Our background paper states that one of the main limitations of the paper that was produced by the Treasury and the Scottish Government is

"that it does not provide any assessment of the confidence intervals likely to be associated with the VAT estimate".

For context, our paper adds that

"the GERS methodology paper states that the 95% confidence interval associated with the GERS estimate of Scottish VAT is +/- £223 million."

If we do not even have that confidence interval information, the potential for volatility and a fluctuating position on VAT in the Scottish budget must be significant. We do not even know what that number is.

Iain Pearce: That is a fair point. The committee may be aware that Her Majesty's Revenue and Customs will be publishing a statistical publication on VAT assignment at the end of this month, which I hope will provide more clarity on statistical confidence intervals around the VAT assignment model estimates.

The Convener: I am sorry to interrupt you there, James, but I just wanted to make sure that that point was covered.

James Kelly: It is a valid point, convener.

We have seen a suggestion that VAT-exempt businesses have not been properly built into the methodology. Is that the case?

Iain Pearce: I am not sure that I fully understand the question. VAT-exempt businesses account for about 15 per cent of total VAT liabilities in the UK. That is reflected in the VAT assignment model, where it is estimated how much VAT liability is coming from those businesses and then we have an estimate of how much VAT they are generating in Scotland. In simple terms, VAT-exempt businesses have been built into the model, with Scotland-specific estimates.

James Kelly: You said that sample sizes have been boosted. What were their original sizes? What have they been boosted to in order to give you more data?

Iain Pearce: The boost in sample size relates only to the household sector of the VAT assignment methodology—it does not relate to other areas such as VAT-exempt businesses. The achieved sample size of the household sector in 2017-18 was, I think, 725 households.

James Kelly: That seems quite a small number. Is one of the problems that the sample sizes are very small?

Iain Pearce: One challenge with the VAT assignment household survey is that, because VAT is quite a complicated tax in the sense that different rates are charged depending on the product, detailed questions need to be asked about household expenditure to understand what products are being purchased. That contrasts with, for example, the Scottish household survey, which has a much larger sample size and does not ask detailed questions on what households are spending money on.

We have an unfortunate situation in that our need to collect detailed information becomes burdensome for the households involved and those collecting the data, which limits the sample size that can be achieved in such detailed surveys.

James Kelly: What is the calculation of the total number of households that contribute to VAT?

Iain Pearce: Do you mean how many households paying VAT would be involved in the survey?

James Kelly: No. You have obviously extrapolated a calculation from the sample of 725 that you mentioned. What does the 725 figure map on to?

Iain Pearce: There are slightly more than 2 million households in Scotland. I expect that nearly all of them pay VAT, because almost any form of household expenditure, other than very basic foodstuffs, includes some form of VAT—even heating or electricity attracts VAT at the 5 per cent rate. It would be difficult for a household not to spend income on VAT.

James Kelly: Right. I repeat that it seems to be a small sample size, given the size of the population that pays VAT.

The Convener: Neil Bibby has a supplementary.

Neil Bibby: Is there any concern that the size of the cash-only economy is higher—or lower—in Scotland than it is in the rest of the UK?

Iain Pearce: That risk is difficult to quantify. There are two aspects to the cash-only economy. One aspect is traders who are below the VAT threshold and who are therefore not required to pay VAT. The model can attempt to adjust for that. Another aspect of the cash-only economy is people who are avoiding paying VAT. We have very little information about that on which to make a judgment as to whether that aspect is different in Scotland.

The Convener: A number of members want to ask about technical issues, but I do not want the topic of the potential devolution of VAT to be lost in the discussion, so I will bring in Murdo Fraser, who has questions about that.

Murdo Fraser: My colleague Adam Tomkins has touched on this issue. We know that VAT devolution is not an option now, so this is a hypothetical question about the situation post-Brexit. If VAT devolution was legally permissible, is it the Scottish Government's view that that is practical and desirable?

Derek Mackay: For reasons that I think are well understood, the purpose of the Smith commission was essentially to enable the Parliament to have the powers to raise money and be responsible for how that money is spent. We used to be a spending Parliament; now we raise our own revenues. Having the power over VAT is more desirable than assignation. The issue with assignation is the level of risk that we carry, because we can never be sure that the analysis to assign an amount was fair. As I have said, the Brexit situation has added to the uncertainty.

The Scottish Government's view is that we want as much devolution as possible, including the devolution of fiscal matters. However, that must be right, appropriate and based on the evidence. We would be supportive of the devolution of VAT. I was not involved in the Smith commission deliberations, but as a Scottish nationalist I naturally argue for the devolution of powers. It is more attractive to have the powers than for revenue to be assigned.

As I say, we have tried to be helpful here, and there is no lack of willingness. The committee is considering the risk—advisers to the committee have surely identified that the issue that we are being asked to consider is the level of risk.

Murdo Fraser: The level of risk with the devolution of VAT would be exactly the same as it is with assignment, although I appreciate that there would be a greater degree of accuracy with devolution. However, the volatility of VAT receipts would be the same with devolution as it would be with any assessed survey model on assignment.

Derek Mackay: It is the volatility of Brexit right now that is adding to the general volatility. If we set that aside for the sake of the discussion, the important point about the devolution of powers is that we would be able to push and pull the levers to adapt to the policy choices. We would be able to be agile in responding to the needs of the economy and setting VAT rates that are appropriate to the circumstances. We would be able to stimulate the economy as appropriate and use the powers as an economic and social lever.

The difficulty is that the methodology is not particularly accountable or transparent, and the VAT that is raised in Scotland cannot be evidenced. Understanding the level of risk that we are carrying leads to material considerations for the budget, because we will have to provide for any shortfall if the block grant adjustment and estimates are not to our mutual satisfaction.

Murdo Fraser: When the committee took round-table evidence on the issue a few weeks ago, I or one of my colleagues asked specifically about the devolution of VAT, and it is fair to say that there was a very negative reaction from the witnesses. They were concerned about the practicality of the devolution of VAT, first, because it would place a substantial additional burden on Scottish business to create a separate Scottish tax point and, secondly, because the nature of VAT is that it flows across boundaries, both within the UK and internationally. For example, a Scottish business might purchase goods or services from a business in Manchester and reclaim VAT that is paid on those goods or services. If we had a devolved system, how would we account for all of that? Do you appreciate that going down that route presents practical challenges and, potentially, a substantial additional cost to Scottish businesses?

Derek Mackay: That is why I propose to discuss the issue further with the Treasury and consider it as part of the fiscal framework review that we have agreed that we will conduct, after allowing a full session in which the Parliament has the powers in the Smith agreement. The risks have been fairly identified and we will have further discussions on them.

We will be better equipped and informed when we have a number of years of evidence on what the numbers produce and what the surveys show. Further data will be released by HMRC. If we have more information, at least we will understand the risks more fully. The alternative is to sign up to something now that might be to the detriment of the finances and the people of Scotland without being convinced about the levels of accuracy. I am minded to have further transition and further accountability around looking at those numbers and the analysis.

I hope that the current Brexit uncertainty will be resolved so that we will not be going through the process at a point of maximum volatility. I am trying to be constructive with the Treasury. It will not surprise Murdo Fraser to know that, as a Scottish nationalist, I support the devolution of fiscal powers to Scotland. However, I acknowledge the committee's concerns about accuracy, what other commentators have said, and the consensus on the level of risk, and I propose to try to find a constructive way forward with Treasury. If we review the issue as part of the fiscal framework review, we will have more data and information. Although we recognise that the proposal was only ever for assignation and not for the power, a change in circumstances might precipitate an opportunity to revisit the discussion.

The Convener: The words "level of risk" have come up a number of times. I think that Angela Constance was particularly interested in that.

Angela Constance: Yes. I am keen to understand a bit more about what level of risk could be tolerated, given that risk can only ever be minimised and can never be eliminated.

Following on from Murdo Fraser's questions, we have known about the potential difficulties for a while. The committee has been looking for a while at the layers of complexity, the problems with having no outturn data, and issues to do with sample size and fluctuations based on sampling as opposed to revenues. It seems to me that those are the practicalities of devolution or, rather, the complexities that we get into when we have partial devolution or partial assignment as opposed to the devolution of powers.

As well as wanting to understand what level of risk could be tolerated, I am interested in what you seek to discuss with the Treasury and what discussions you have had to date. Could you give us a flavour of that? Do the Treasury and the UK Government share some of your views about the difficulties? They are not manufactured difficulties. At their core, they are political difficulties, but some of what we are talking about is just technical stuff, of which one would hope there could be a shared understanding and a shared acceptance.

10:45

Derek Mackay: Those are appropriate questions. You asked about other views on the difficulties. Late last year, the Fraser of Allander institute said:

> "Implementing a policy that exposes the Scottish budget with unnecessary risk, simply to increase the impression of accountability, is not a good way forward."

On 6 December, the institute said:

> "A key aim of the Smith Commission was to improve accountability and make Scotland's politicians responsible for the money that they spent. Unfortunately rather than helping to deliver this aim, the current proposals for VAT assignment risk undermining that principle."

That is the view of independent economists on what has been agreed.

Officials of the two Governments have been working together, but political sign-off at the joint exchequer committee, which involves the Treasury and the Scottish Government, is required. I have been open in saying to the committee that we engaged constructively in the work to build up the methodology to see what it would produce. In my view, it has produced a high level of risk, which Jonathan Sewell will be able to talk about. There is a high level of risk because of the lack of outturn data, the questions about accuracy and the volatility associated with the Brexit situation.

I have been briefed by civil servants on the work that has been going on in anticipation of potential sign-off at the joint exchequer committee. I have raised my concerns about the level of risk that the Scottish Government would carry and the material impact that that would have on the Scottish budget with Liz Truss, the Chief Secretary to the Treasury, in writing and in person. I did that at my most recent meeting with her, and I propose to do so again at the next finance ministers' quadrilateral, which will be in Scotland; the date is yet to be confirmed. I have raised those issues with the Treasury as I have become concerned about them, but we have not been able to reach an agreement to take to the joint exchequer committee.

I ask Jonathan Sewell to cover the level of risk from a civil service point of view.

Jonathan Sewell: As the cabinet secretary said, there are areas of risk. Some are potentially more measurable than others. A lot of the work that has been done has been an attempt to identify and measure those areas, where we can. Unfortunately, there is quite a lag on some of the data.

As has been mentioned, HMRC will produce additional data at the end of the month, which should help us but, because of the various areas of risk and the differing abilities to measure them, it is hard to come up with an overall risk figure. Our way of thinking about the issue is that an appropriate level of risk should be proportionate to our ability to manage it. We are working to gain an understanding of that.

As has been said, it is part and parcel of taxation that there is volatility with any tax receipts; some taxes are more volatile and some are less volatile. VAT is not terrible in that respect.

However, with the assignation process, we are exposed to the risk that is generated by the survey approach. That is more difficult to handle, because it is not based on real performance, which makes it hard to measure and address.

We are doing the best that we can to find out the information. Angela Constance is right that we have been looking at the issue for a while, but one problem pretty much across fiscal devolution is that lags tend to be associated with the data. VAT assignment involves £6 billion, which is a substantial figure. It is therefore best to take time to understand the position and not to expose the budget to significant risk.

Derek Mackay: Ms Constance asked what I am asking the Treasury to do about the issue. The transitional year was to be 2019-20, with implementation in 2020-21. Given all the issues, which I hope have been well aired this morning, I am saying that we should have further discussions and look at extending the transition period. If we understood the model more, we would know what the numbers told us. We also hope that we will have EU exit certainty—the Government's position on Brexit and where Scotland lies in that is well understood.

We want to be in a much stronger position to understand all that before it impacts on the Scottish budget. It feels timely to discuss VAT powers at the time of the fiscal framework review, which is what I am asking the Treasury to do, rather than proceeding with the existing level of risk.

Alexander Burnett (Aberdeenshire West) (Con): What have been the costs of the exercise to calculate the assignment? I appreciate that some costs are one-offs for the first couple of years, but how much will the exercise cost annually? More important, how much do the costs relate to the accuracy of the figures? Iain Pearce mentioned that only 725 households will be surveyed. How many households would need to be surveyed to improve the accuracy?

Derek Mackay: The total cost is £1 million, of which the Scottish Government pays half. The sum that we are assessing is about £6 billion, so you will understand why accuracy and risk are significant.

Alexander Burnett: What is the relationship between the money that is being spent and the accuracy? How many more households would be needed to improve the accuracy? Has that been assessed?

Derek Mackay: We could survey more people, but the principal issue of placing estimates upon estimates in a model that is untested has never been resolved. We could pay for more surveys, but that would not address the issue of placing survey upon survey with no outturn or reconciliation, in a volatile period and without having tried the model. I do not think that my officials would say that there is any amount that could be spent to resolve those issues.

Jonathan Sewell: Marginal improvements could be made, but the overall accuracy would not be affected, as the cabinet secretary has said.

Willie Coffey: I will ask you to clarify a point about the 95 per cent confidence interval. Are you saying that you cannot work out a figure that gives you 95 per cent confidence? Is the level so far below that percentage that proceeding would be too risky?

Derek Mackay: The question is good but, when we are talking about assigning £6 billion, the accuracy level is really important. If there were a material impact of tens of millions of pounds on the Scottish budget, that would be significant—it would mean tens of millions of pounds that we could not spend or that we would have to find from elsewhere. What tolerance level for being wrong by would the committee accept and ask the people of Scotland to carry, perhaps unfairly? The assignation involves £6 billion. Even a tiny margin of error on either side of the calculation could lead to an outcome that was materially significant to the budget.

Willie Coffey: Would there be merit in getting agreement about a ceiling and a floor for variation, so that, no matter what scary figures you got, they could not go above or below certain amounts?

Derek Mackay: That is a good suggestion. If the committee shared the view of others about the level of risk, I would be minded to make such a suggestion to the Treasury. The Treasury might propose a mechanism that would resolve our concerns, although it has not done that so far. Perhaps it could create transitional arrangements that would mean that there was no financial detriment.

The UK Government might propose things that I would be open to, such as no financial detriment, recognising that we cannot push and pull levers here to fix the VAT issue. If the UK Government wants to respond with some sort of protection or mitigation, of course, I will engage with it constructively.

My point right now is that, short of that, not implementing VAT assignation until we have more data and a deeper understanding of what the model produces feels like the right thing to do. However, it is a good question and, if the Treasury wishes to introduce some form of mitigation as a transitional arrangement, that might be helpful and we could consider it. I would, of course, bring any such arrangement back to the committee.

Willie Coffey: The Fiscal Commission will have to build its VAT forecasts into future budgets, and I imagine that it is important that the figures that it uses are at least sort of reliable, so that they can be used.

Derek Mackay: Again, the Fiscal Commission's forecasts are absolutely significant in relation to the whole block grant adjustment and reconciliation.

Willie Coffey: Will you be bound by that?

Derek Mackay: Yes, we are bound by those arrangements in terms of the Fiscal Commission's forecasts.

Willie Coffey: Okay.

The Convener: What discussions have you had with the Fiscal Commission? Trying to estimate this must be terrifying the people there, for want of a better description. What discussions have you had with them?

Derek Mackay: I am happy to ask officials to declare the level of terror within the Fiscal Commission. I think that it is enjoying its role, but it recognises, as the committee is well aware, that, at least where we have outturn data, there is a moment of truth—a point at which we can reconcile figures that were based on estimates. The difficulty is that you never quite get to that point. Jonathan Sewell can cover the engagement with the Fiscal Commission.

Jonathan Sewell: Yes, we have engaged with the Fiscal Commission—

The Convener: I thought that you were going to say, "Yes, they are terrified."

Jonathan Sewell: I could not possibly comment on the level of terror. The Fiscal Commission would have to offer its own response to that. We have engaged with it regularly on this matter, and the Fiscal Commission has engaged with HMRC on it. Again, it is for the Fiscal Commission to comment on this, but it agreed that it faces some of the same challenges as us in interpreting the data.

Emma Harper: I am interested in accountability issues. The Fiscal Commission is responsible for forecasting receipts that are assigned to the Scottish budget; the OBR is in charge of producing VAT forecasts for the UK as a whole; the UK Government and the Scottish Government have jointly developed this methodology; and we have just heard lots of words about risk, data, boosted data and accuracy. Who is accountable?

Derek Mackay: I am accountable to the Parliament as Scotland's finance secretary. That is partly why I am expressing the view that I am not convinced about the level of risk that we would be carrying. I am accountable for what we sign up to in the joint exchequer committee, and then I am accountable for Scotland's budgets. The Fiscal Commission is also accountable to Parliament; it publishes its forecasts and it is accountable to this committee. You can challenge it on its evidence when it appears before the committee.

We work with the Fiscal Commission in a constructive way, as you would expect, not to change forecasts but to provide a constructive challenge. There are various strands of accountability in how all the different institutions work and how we operate. I think that I have been open and transparent with this committee in explaining that I share some of the concerns that you and others have raised about the level of risk. For the reasons that I have explained, that level of risk has not been resolved, and that is what is leading me to think that we should engage further with the Treasury.

Emma Harper: To reiterate, is Brexit—and the uncertainty, instability and all the other issues around it—just another issue in the whole mix of things that is leading to a proposed delay in the process until we have better data?

Derek Mackay: Yes. This is the transitional year. We will have one year of data. The timing is absolutely not right to implement VAT assignation in 2020-21. For all the reasons that I have given to the committee, we need more time and more engagement with the Treasury to try to resolve this.

The Convener: It is helpful that you have introduced the issue of transparency. Tom Arthur is also interested in transparency and public confidence in the process.

Tom Arthur: This is clearly a very complicated matter. Fundamental to the whole Smith Commission process and the Scotland Act 2016 was increasing the accountability of the Parliament. Given the challenges around wrestling with this issue and transparency, does it raise broader issues about democratic accountability and ensuring that the public understands the issue, considering the complexities of the fiscal framework?

11:00

Derek Mackay: The fiscal framework is incredibly complex. When we come to the published outturn figures on income tax, for example, at least we will know exactly what tax was paid, and we can then undertake a reconciliation with the forecasts that were made and that we were bound by. The difficulty is that we will never have that outturn or know, in the real world, what tax was collected in Scotland. My concern is about the level of risk, volatility and uncertainty and about not being convinced of the robustness of the model, although we could give the model more time to run before we make a decision on its appropriateness.

My point is about timing. If there was a major shock to the economy—if Brexit or a no-deal Brexit went ahead—that would be the worst possible time to engage in an estimation process that would never have a reconciliation. In fact, if the figures were not in our favour, it could mean that we would have to make decisions that would have a material impact on Scotland's budget and the decisions that we would make as a Parliament. I do not think that that complexity would help with accountability or transparency.

Tom Arthur: I have a final question, to ensure maximum transparency. I noticed that, during our proceedings, a member of this committee tweeted a suggestion that VAT is a power. Just to avoid any doubt, can you confirm—absolutely, once and for all—that VAT is not a power that is being devolved to the Scottish Parliament but an assignation.

Derek Mackay: Convener, I have been paying so much attention to the questions from members that I have not engaged in Twitter while I have been giving evidence to the committee. In case someone has tweeted that VAT is a power and not an assignation, I can confirm that this would be an assignation of a tax that would be based on estimates, not a power—we have no power over VAT in Scotland.

Tom Arthur: Thank you for clarifying that.

The Convener: I do not know what to say after that. We will have an investigation—that is what we will do. [*Laughter*.]

Derek Mackay: Have an inquiry. Find the Twitter tweeter.

The Convener: Cabinet secretary, I want to understand the landscape of the discussions between yourself, the Treasury and HMRC. The fiscal framework document suggests that the discussions are held between HMRC and the Scottish Government and then go through the JEC. I do not want to go into the difference between the Treasury and HMRC, but is it HMRC or the Treasury that we are dealing with on this issue?

Derek Mackay: It is the Treasury, with regard to the politics and the agreement.

The Convener: If we decide to take further evidence, that might help us to determine what would be more appropriate.

Derek Mackay: Naturally, HMRC would inform the Treasury in the same way as Revenue Scotland would inform the Scottish Government.

The Convener: That is helpful.

Again, I thank our witnesses very much—particularly the cabinet secretary, who has been here for almost two hours. I also thank committee members for their questions.

11:03

Meeting continued in private until 11:12.

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Published in Edinburgh by the Scottish Parliamentary Corporate Body, the Scottish Parliament, Edinburgh, EH99 1SP

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