



The Scottish Parliament  
Pàrlamaid na h-Alba

## FINANCE AND CONSTITUTION COMMITTEE

### AGENDA

**10th Meeting, 2019 (Session 5)**

**Wednesday 8 May 2019**

The Committee will meet at 9.15 am in the David Livingstone Room (CR6).

1. **Earnings in Scotland:** The Committee will take evidence from—

Derek Mackay, Cabinet Secretary for Finance, Economy and Fair Work, Victoria Beattie, Head of Workplace Equalities Team, and Simon Fuller, Deputy Director, Economic Analysis, Scottish Government.

2. **Scottish VAT Assignment:** The Committee will take evidence from—

Derek Mackay, Cabinet Secretary for Finance, Economy and Fair Work, Jonathan Sewell, Head of Income Tax and Tax Strategy Unit, and Iain Pearce, Economic Adviser, Scottish Government.

3. **Work programme (in private):** The Committee will consider its work programme.

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The papers for this meeting are as follows—

**Agenda Item 1**

Cover note

FCC/S5/19/10/1

**Agenda Item 2**

Cover note

FCC/S5/19/10/2

**Agenda Item 3**

PRIVATE PAPER

FCC/S5/19/10/3  
(P)

## Finance and Constitution Committee

10th Meeting, 2019 (Session 5), Wednesday 8 May 2019

### Earnings in Scotland

#### Introduction

1. At its meeting on 6 February 2019, the Committee agreed to undertake some work on earnings in Scotland and agreed its approach to this work at its meeting on 27 February 2019. This note provides some context for the Committee's evidence session with the Cabinet Secretary for Finance, Economy and Fair Work.

#### Background

2. Employment in Scotland comprises of public sector employment (20.9 %) and private sector employment (79.1 %) as of December 2018.<sup>1</sup> In March 2019, the unemployment rate in Scotland fell over the quarter to 3.4% whilst for the UK as a whole it is 3.9%. Employment increased to 75.3%, just below the UK wide figure of 76.1%<sup>2</sup>.

3. The Committee is interested in how earnings in Scotland compare to the rest of the UK and how public sector pay compares with private sector pay. In addition, the Committee has had an ongoing interest in the gender balance of the Scottish income tax base.

#### Evidence

4. The Committee held a roundtable discussion at its meeting on 24 April<sup>3</sup> and the Committee's adviser produced a paper in advance of the session which is attached at the annexe to this note. Discussion focussed on following themes:

- **How public sector pay compares with the private sector**
- **How pay in Scotland compares with the rest of the UK**
- **Changes in the labour market and impacts on earnings**
- **Distribution of earnings and implications for revenues**

5. During the session, the Committee was told that the higher levels of pay in the public sector compared to the private sector reflected the differences in the work that is done in the public and private sectors. We heard that typically, public sector work is more skilled, although there is a spread across the distribution of the workforce, which explains the higher levels of pay.

6. We also heard that, despite the living wage campaign being both important and successful in Scotland and supported by all our witnesses, and despite its importance

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<sup>1</sup> <https://www.gov.scot/publications/public-sector-employment-scotland-statistics-4th-quarter-2018/>

<sup>2</sup> <https://sp-bpr-en-prod-cdnep.azureedge.net/published/2019/3/20/Labour-market-update--March-2019/SB%2019-14.pdf>

<sup>3</sup> [33](#)

for low-paid workers, it has not had a material effect on average earnings due to the small number of people effected.

7. The Committee explored wage growth levels across Scotland, given the direct impact income tax receipts now have on the Scottish Budget. We were told that slow wage growth is directly related to weak productivity growth and this low productivity growth is primarily as a result of the financial crisis. It was suggested boosting productivity across all different sectors in Scotland would involve greater use of technology and would require employers, employees and Government all working together on the best way forward.

8. We were told that achieving higher income tax revenues requires pay growth across the distribution, but that pay growth at the top of the distribution (i.e. for high earners) has a relatively larger impact on tax revenues given the higher tax rates applied. However, pay growth at the top of the earnings distribution, which is important for tax revenue growth, should not be at the expense of pay growth across the earnings distribution. It was argued that it is much more sustainable to try to boost lower-paid and medium paid workers' career progression to achieve sustainable growth.

9. The Committee heard that despite record levels of employment in Scotland, changes to the labour market, such as reduced rates of overtime being paid, more part-time workers, has meant that this has not necessarily translated into earnings growth – although the main reasons for weak real pay growth are weak productivity growth mentioned above, combined with depreciation in the pound.

### **Next steps**

10. The Committee will agree next steps following the evidence session with the Cabinet Secretary.

**Committee Clerks,  
May 2019**

## **WAGES AND EARNINGS IN SCOTLAND: SOME TRENDS AND ISSUES**

### **BRIEFING BY THE ADVISER, DAVID EISER**

#### **INTRODUCTION**

In advance of the Committee's evidence session on earnings in Scotland on 24 April, this paper outlines a number of trends and issues which the Committee may want to raise with the panel.

The paper draws out five broad issues that seem particularly relevant to ongoing policy debates:

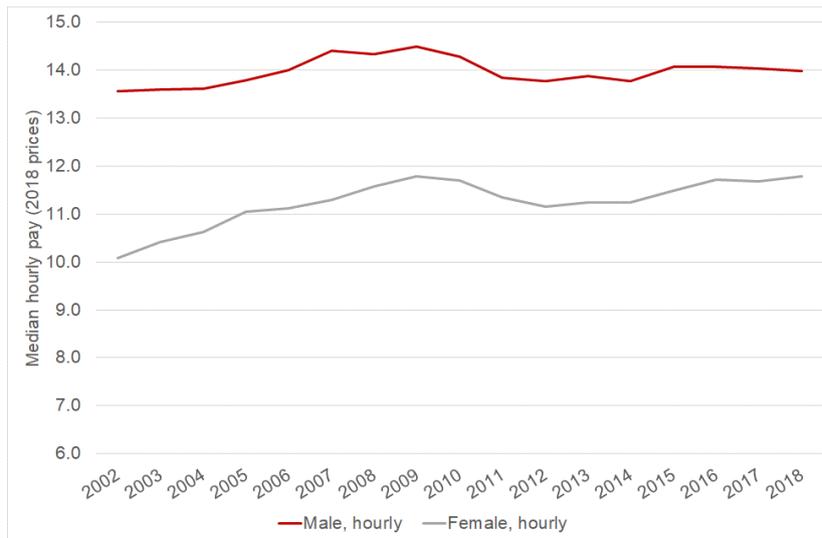
- Recent trends in wage growth, and the debate over causes of recent wage stagnation
- Trends in the gender pay gap
- Earnings trends in the public and private sector
- Trends in earnings in Scotland relative to those in the UK – relevant now in the context of the fiscal framework
- Trends in earnings growth across the earnings distribution (i.e. earnings inequality).

The data in this paper is drawn from the Annual Survey of Hours and Earnings (ASHE). ASHE is a random 1% sample of employees. It is widely recognised as the best source of employee earnings data, although it does not include the self-employed.

#### **LONGER-TERM TRENDS IN WAGES: WAGE STAGNATION AND ITS CAUSES**

The period since the Great Recession has seen an unprecedented stagnation in wages. In Scotland, real terms median hourly pay in 2018 remained 1.6% below the 2009 level. Among women the story is slightly more positive – real hourly pay in 2018 matched that in 2009, whilst for men real wages are 3.5% lower than at their peak (Chart 1).

#### **Chart 1: Median hourly pay of male and female employees**



Source: ASHE

Stagnation or decline in real pay over such a long period is unprecedented. The causes of pay stagnation have been extensively debated. One set of explanations relates to a decline in the [bargaining power](#) of workers relative to firms. This could result from a combination of: a rise in [labour supply](#) (as a result of later retirement, a more coercive welfare system, and immigration); and a rise in the [monopsony power](#) of firms (i.e. if there are fewer employers, those employers have relatively greater power in the wage-setting process). Somewhat relatedly, it may also reflect increases in the [non-wage elements](#) of firms' labour costs (such as pension contributions).

Perhaps more strikingly, real wage stagnation is likely to reflect the stagnation in productivity growth. The causes of this 'productivity puzzle' are in turn debated, but probably relates in part to the UK's historically low levels of investment, a trend which has been accentuated since the recession, possibly combined with weak management practices and weak levels of innovation. Real wage stagnation is likely to have been further accentuated since the financial crisis by sterling depreciation which puts upward pressure on prices (thus reducing real wages).

Stagnation in weekly earnings has been even more marked than is the case for hourly pay, reflecting a small decline in average hours worked. Compared to 2009, weekly earnings in 2018 were 3.9% lower for men and broadly unchanged for women.

## THE GENDER PAY GAP

On 3 April 2019, the Scottish Government published its [latest report](#) on the gender pay gap (looking at employer perceptions and methods for reducing the gap), and this included an analysis of the latest pay gap data.

The gender pay gap refers to the difference in hourly earnings between men and women, expressed as a percentage of men's average hourly earnings. The gender pay gap can be calculated as the difference in either the mean or median hourly earnings. Pay gaps may be calculated by comparing full-time workers, part-time workers or all workers. The official measure of the gender pay gap excludes overtime.

Chart 2 shows the evolution of the pay gap for median wages for full-time workers. The pay gap in Scotland had been falling reasonably quickly until 2011, but the gap

has closed relatively more slowly since then. It should be noted that the pay gap is larger if average rather than median pay is considered, and larger too if all employees rather than full time employees only are considered (as women are more likely to undertake part-time work).

**Chart 2: Gender pay gap (median hourly wages for full-time workers)**



Source: Scottish Government, [analysis of ASHE 2018](#)

It remains unclear to what extent the reporting requirements of the Equality Act 2010 (Gender Pay Gap Information) Regulations 2017 (whereby private sector companies employing more than 250 employees have to report their gender pay gaps) will contribute to further reductions in the gap.

It will be interesting to hear participants' views of the causes of the decline in the pay gap – to what extent does it reflect changes in the occupational structure of male and female employment, changing attitudes in relation to childcare responsibilities, or reduced forms of discrimination.

## WAGE GROWTH IN SCOTLAND AND RUK

Under Scotland's new Fiscal Framework, the Scottish budget will be better off than it would have been without tax devolution if revenues per capita grow more quickly in

Scotland than in rUK. One of key determinants of growth in income tax revenues is earnings – faster earnings growth should equate to faster revenue growth.

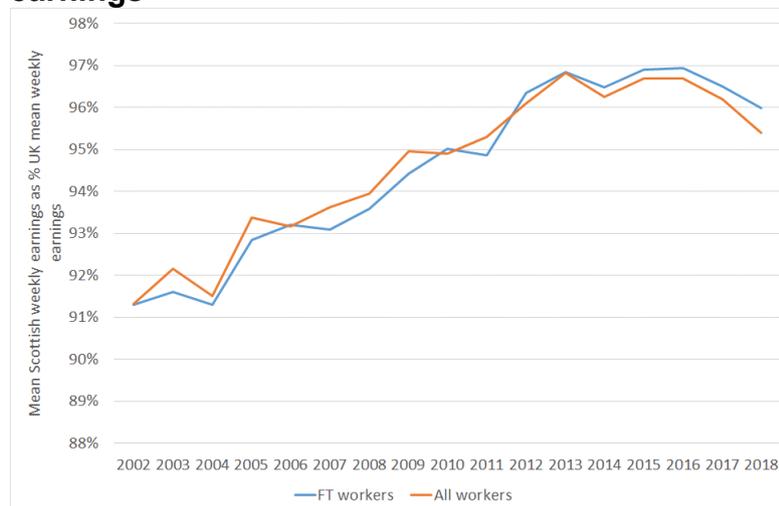
Chart 3 shows Scottish average weekly earnings as a percentage of average UK earnings. Between 2002 and 2013 there was a remarkable convergence of Scottish earnings to the UK – average Scottish earnings were 91.5% of the UK average in 2002 (i.e. 8.5% below UK earnings) but were just 3% below UK earnings by 2013.

In other words, Scottish wages grew more quickly than UK wages during this period, although remain slightly lower than the UK on average.

Between 2013 and 2016 there was no further convergence of Scottish earnings to the UK average. Moreover in 2017 and 2018 Scottish average wages grew less quickly than in the UK. This relative slowdown in Scottish wage growth is also reflected in a relative slowdown in ‘real time’ [PAYE tax data](#) published by HMRC.

Understanding the causes of the relative Scottish earnings slowdown is an ongoing priority – as is determining what the Scottish Government’s policy response should be.

### Chart 3: Scottish average weekly earnings as a percentage of UK average earnings



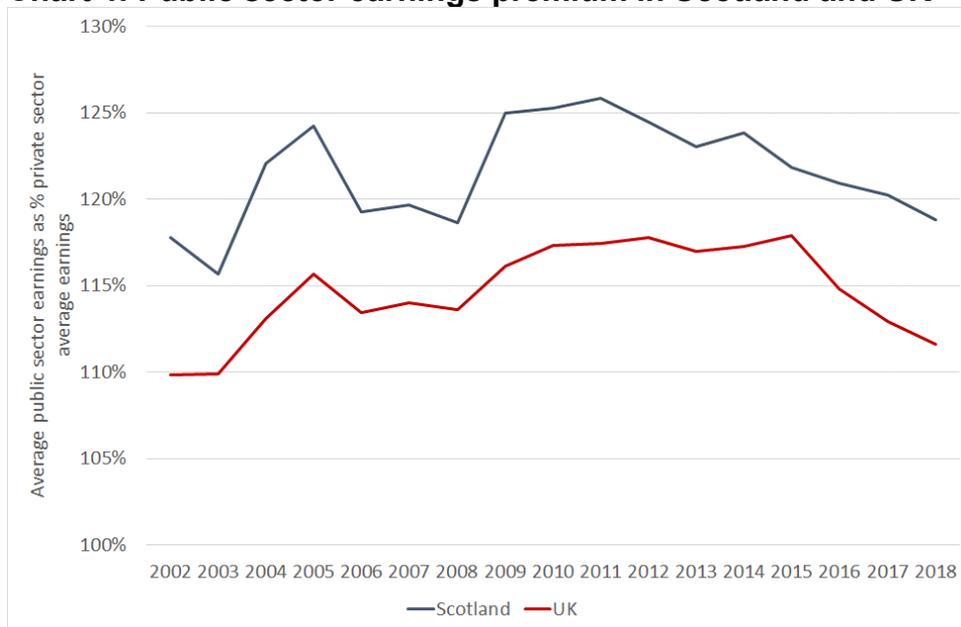
Source: Annual Survey of Hours and Earnings

## PUBLIC AND PRIVATE WAGE GROWTH

In Scotland and in the UK, average earnings are higher in the public as opposed to the private sector, reflecting differences in the average skill/qualification level in the two sectors. The public sector premium is higher in Scotland than in the UK as a whole, although the shape of the premium over time follows a similar pattern. The public sector premium rose during the recession and its aftermath, perhaps reflecting greater flexibility in private sector wages and hiring decisions, but has been declining in recent years, reflecting public sector wage restraint (Chart 4).

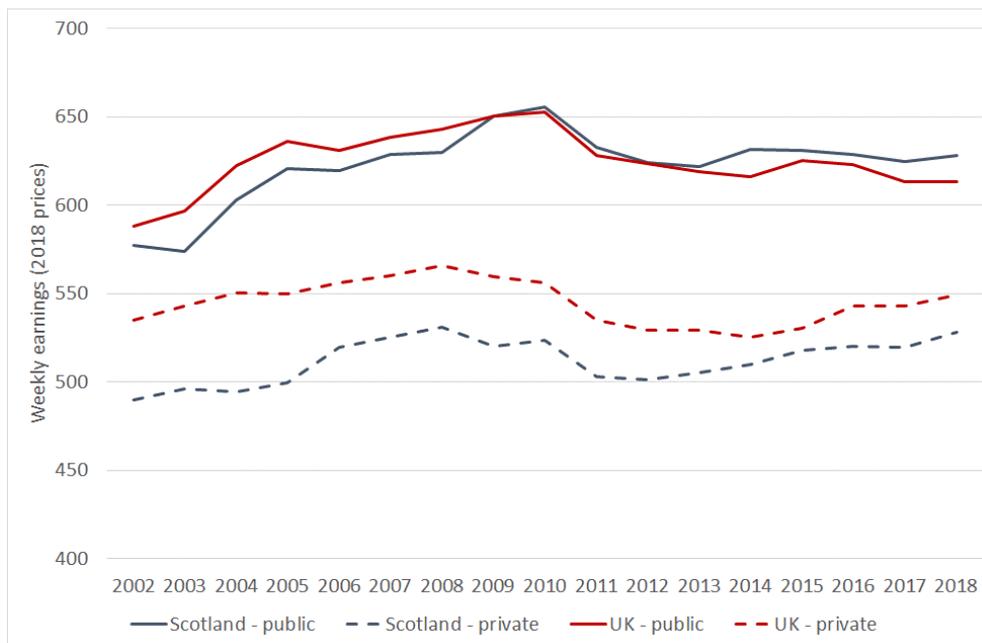
Chart 5 shows that Scottish private sector earnings have tended to converge towards those in the UK (other than in the most recent couple of years), whilst public sector earnings in Scotland are now above those in the UK (whilst having been below the UK pre-recession).

**Chart 4: Public sector earnings premium in Scotland and UK**



Source: Scottish Government, [analysis of ASHE 2018](#)

**Chart 5: Median weekly public and private earnings, Scotland and UK**



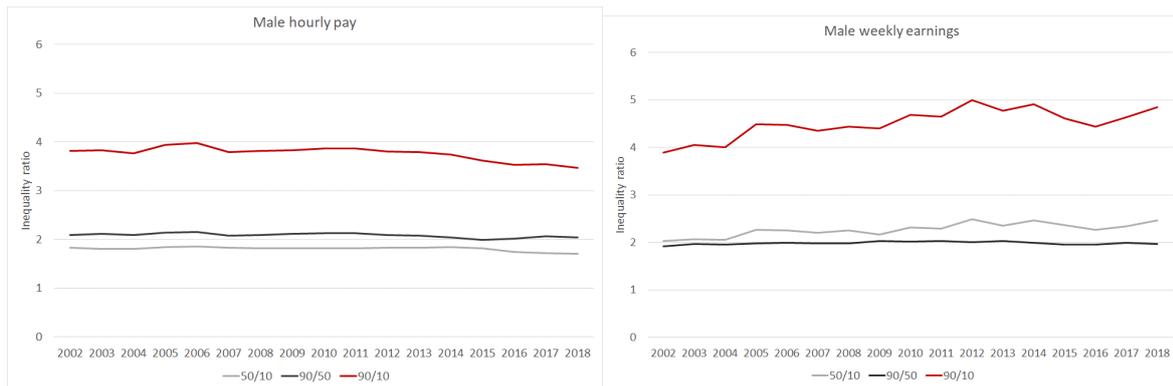
Source: Scottish Government, [analysis of ASHE 2018](#)

## RECENT CHANGES IN EARNINGS INEQUALITY

How has earnings inequality evolved in recent years? It is useful to distinguish inequality in hourly pay from inequality in weekly earnings. For men, we can make the following observations (Chart 6):

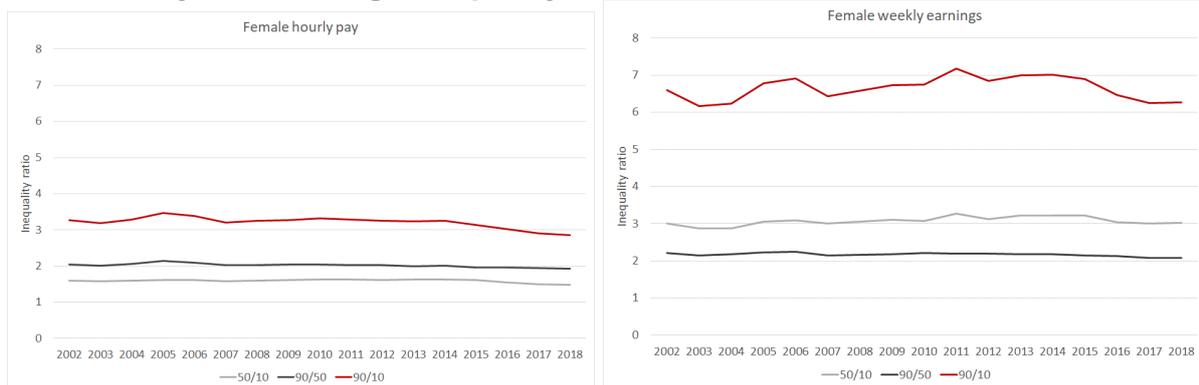
- Inequality in hourly pay has declined slightly in recent years, and particularly so in 2016. The decline in wage inequality in 2016 reflected a substantial rise in wages at the tenth percentile relative to the median (a decline in the 50/10 ratio). Since the national living wage was introduced in April 2016, it seems reasonable to hypothesise that this fall in hourly pay inequality was driven by that introduction.
- However, despite falling inequality of hourly pay, inequality of weekly earnings has increased quite substantially. This largely reflects an increase in an increase in the 50/10 ratio.
- The rise in inequality of weekly earnings in the 'lower tail' is consistent with the rise in part-time working among men. In other words, despite the narrowing of the dispersion of hourly pay, this is offset by the greater dispersion of working hours. In particular, what seems to have been happening in recent years is that, whilst average hours worked by men is declining, the decline in hours worked has been proportionately greater among men working in relatively low paying jobs than among more highly paying jobs.

**Chart 6: Pay and earnings inequality for males in Scotland**



Source: ASHE. Notes: the 90/10 line shows the ratio of wages at the 90<sup>th</sup> percentile to wages at the 10<sup>th</sup> percentile. The 50/10 line shows the ratio of wages at the median to wages at the 10<sup>th</sup> percentile; and the 90/50 ratio shows the ratio of wages at the 90<sup>th</sup> percentile to wages at the median. In all cases, a larger number means greater dispersion, i.e. higher inequality.

For females the story on hourly wage inequality is the same as for men – hourly wage inequality has been declining, particularly in the last few years. However, what is different from the male story is that weekly earnings inequality has not tended to increase as much – hours worked by women have become less rather than more polarised, so reductions in hourly pay inequality have not been offset by hours changes (although weekly earnings inequality remains higher for women than men, given the larger proportion of part-time working).

**Chart 7: Pay and earnings inequality for females in Scotland**

Source: ASHE

The broad trends described here – a slight narrowing of hourly pay inequality, offset for men by a greater dispersion in hours worked – are not unique to Scotland but reflect [similar trends](#) across the [UK](#) (Clarke and Bangham 2018; Belfield et al. 2017; Blundell et al. 2018). Moreover the trend towards widening weekly earnings inequality among men, driven by increased part-time working, is not specific to the post-recessionary period but reflects the continuation of a trend that has been observed for at least the last 20 years.

A challenge for future research is to understand the extent to which the rise in male part-time working reflects supply-side or demand-side factors. In other words, does it reflect a tendency for men to choose to work fewer hours – perhaps to balance work with study, family life or a transition into retirement – or does it reflect greater difficulty in accessing the hours of work that they desire?

The increase in part-time working among males, particularly those in relatively low-paid jobs, also contrasts with the US experience. Unlike the UK, the US has not seen increases in male part-time working, although the overall male employment rate in the US has declined, whilst it has been increasing in the UK.

David Eiser

## Finance and Constitution Committee

10th Meeting, 2019 (Session 5), Wednesday 8 May 2019

### Scottish VAT assignment

#### Introduction

1. At its meeting on 6 February 2019, the Committee agreed to explore the methodology being used for Scottish VAT assignment given the impact that it will have on the Scottish Budget. This paper note provides some context for the Committee's evidence session with the Cabinet Secretary for Finance, Economy and Fair Work.

#### Background

2. The Scotland Act 2016 provided for the first 10 pence of the Standard Rate of Value Added Tax (VAT), and the first 2.5 pence of the Reduced Rate, to be assigned to the Scottish Government.

3. The Fiscal Framework set out that VAT assignment will be implemented in 2019-20. There will be a one-year transitional period during which VAT assignment will be forecast and calculated, but with no impact on the Scottish Government's budget. From 2020-21 the Scottish Government's budget will in part be determined by forecast and reconciled with final estimated VAT receipts in Scotland.

4. The assignment of VAT will be based on a methodology that will estimate expenditure in Scotland on goods and services that are liable. The draft model for calculating Scottish VAT receipts<sup>1</sup> was published by HM Treasury on 22 November 2018 and is expected to be finalised by the Joint Exchequer Committee in spring 2019.

5. It highlights that the household component of the model accounts for around 70% of total VAT receipts and arises from spending on household goods and services. The estimate of UK households' total VAT liability is based on the Household Final Consumption Expenditure (HHFCE) quarterly data set classified by Classification of Individual Consumption by Purpose (COICOP), at current prices and not seasonally adjusted (CPNSA), published by the ONS.

#### Committee interest

##### *Forecasts*

6. On the 12 December 2018, the Scottish Fiscal Commission (SFC) published its first full VAT forecast in the Economic and Fiscal Forecasts publication<sup>2</sup>, which accompanied the 2019-20 Scottish budget.

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<sup>1</sup> <https://www.gov.uk/government/publications/scottish-vat-assignment-summary-of-vat-assignment-model>

<sup>2</sup> <http://www.fiscalcommission.scot/media/1435/scotlands-economic-and-fiscal-forecasts-december-2018-full-report.pdf>

7. The forecasts are based on the concept of a VAT total theoretical liability which is the total value of VAT that could theoretically be collected from the tax base across various sectors. The report outlines the variability in the assignment outturn model.

#### *Volatility*

8. During our pre- budget and budget scrutiny, the Committee explored the methodology being used to forecast VAT assignment and how robust it was. The Committee was told that the Cabinet Secretary continued to have concerns that the assignment of VAT to Scotland will be based on a statistical model rather than actual outturn VAT receipt data.

9. The Committee concluded<sup>3</sup> that basing VAT assignments for Scotland on estimated figures could introduce further volatility into Scotland's finances and recommended that both Governments should continue to review the methodology used for assigning VAT to Scotland during the implementation year to ensure its robustness and reduce the risk of introducing yet further volatility into the Scottish budget.

#### **Roundtable**

10. The Committee held a roundtable discussion at its meeting on 13 March where the discussion focussed on the following themes:

- **How VAT can be assigned to Scotland effectively**
- **The robustness and transparency of the VAT assignment methodology**
- **Issues around VAT forecasting and risks to the Scottish Budget**

11. The Committee's Adviser produced a paper in advance of the roundtable session which is attached at the **annexe A** of this note.

12. Following the roundtable session, the Committee wrote to the Cabinet Secretary on issues raised during discussion, including the statistical uncertainty inherent in forecasting and estimating VAT receipts in Scotland, the data sources being used in the VAT assignment model and the sample sizes used. This letter is attached at annexe B to this note. The Cabinet Secretary welcomed the Committee's interest and said he will discuss the issues raised in our letter during this evidence session.

#### **Next steps**

13. The Committee will agree its next steps following the session with the Cabinet Secretary.

**Committee Clerks,  
May 2019**

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<sup>3</sup> [https://www.parliament.scot/S5\\_Finance/Reports/Budget\\_Report\\_201920\\_-\\_FINAL\(2\).pdf](https://www.parliament.scot/S5_Finance/Reports/Budget_Report_201920_-_FINAL(2).pdf)

## Annexe A

## Scottish VAT Assignment: questions arising from the paper ‘Summary of Assignment Model’ – David Eiser, Adviser

### Introduction

Following the recommendations of the Smith Commission, the first ten percentage points of the standard rate of VAT and the first 2.5 percentage points of the reduced rate of VAT will be assigned to the Scottish Government’s budget.

The Scottish Government will have no powers to vary VAT rates or exemptions, but the Scottish budget will be influenced by the growth rates of the assigned Scottish VAT revenues relative to the equivalent rUK revenues.

The 2019/20 Budget will for the first time include a forecast of Scottish VAT. However, 2019/20 will be a transitional year in which, although VAT forecasts appear in the budget, these will have no effect on the budget. From 2020/21, assigned VAT *will* affect the budget to the extent that the Scottish share of VAT could grow relatively more quickly or slowly than the equivalent rUK revenues.

The major challenge with assigning VAT is that, unlike with other taxes, there will never be any outturn data for Scottish VAT. As a result, assigned Scottish VAT will need to be estimated.

The extent to which it might make sense to partly base the Scottish budget on an estimate of a revenue depends on how reliably the revenue can be estimated (as well as the extent to which that revenue can be estimated transparently).

UK and Scottish Government officials have been working together over the past two years to develop an agreed methodology to estimate Scottish VAT. The paper published in November summarises the results of this work<sup>4</sup>.

### The VAT Assignment methodology

In broad terms, the model works by applying the VAT rates to estimates of expenditure in Scotland. This gives an estimate of the VAT Total Theoretical Liability (VTTL) which is then adjusted to account for, for example, the fact that some expenditure by Scottish households takes place in other parts of the UK (and some expenditure by English or Welsh residents takes place in Scotland). It is also adjusted to account for the fact that some expenditure is on businesses who may be below the VAT threshold.

Expenditure is largely estimated from a wide range of publicly available survey data, but also from some data held internally to HMRC (including VAT registration information and self-assessment data).

The strength of the Paper is that it explains what is a very complex process relatively simply. But the disadvantages are that it leaves unanswered questions about the likely level of accuracy of the method proposed, and it is sometimes unclear why a particular approach over others has been selected. **Limited assessment of robustness:** The main element of relevant expenditure is by the household sector (household purchases account for around 70% of VAT receipts). The Scottish share of UK

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<sup>4</sup> Scottish VAT Assignment: Summary of Assignment Model. HM Treasury (2018) <https://www.gov.uk/government/publications/scottish-vat-assignment-summary-of-vat-assignment-model>

household expenditure is derived from various surveys, but most importantly the Living Costs and Food Survey. The Paper states that HMRC and the Scottish Government have jointly sponsored a boost to the LCFS sample size, but it does not say what the sample size will be following this boost, nor does it make any assessment of the adequacy of the sample size. The paper also makes no attempt to assess the robustness of other data sources, such as the use of various tourism and visitor surveys (the International Passenger Survey, the GB Day Visits Survey and the GB Tourism Survey).

- **Limited justification for approach:** The Scottish share of central government expenditure (some of which is not VAT recoverable) is calculated using labour market data – but it is not clear why this approach is used rather than drawing on public spending data.
- **Lack of detail on data used:** In some cases, only partial information is provided on data sources. For example, expenditure on house building is calculated on the basis of ‘construction industry data from the ONS’ – although it is not particularly clear what this is. ‘HMRC internal data’ is used to calculate VAT refunded to museums and various other elements of the model.
- **VAT exempt businesses:** The lack of detail is particularly apparent in relation to VAT exempt businesses, an important element of the calculation of VAT receipts (accounting for 16% of the tax base). (Sales of VAT exempt services are not subject to VAT, but the suppliers of these services cannot reclaim the VAT paid on its inputs, unlike the case of zero-rated goods). The UK VAT exempt sector includes financial services, as well as various other services in health, social care, education and postal and courier services. The Paper states that the model calculates the VAT incurred in each of these sectors at UK level by using ‘confidential HMRC data’ and ‘intermediate consumption figures’ but gives no further information on this, and then says that the ‘Scottish share of VAT in the UK exempt sector is calculated using labour market data’. No assessment is given of the appropriateness of this approach, nor on how sectors identified in the labour market data are mapped onto the VAT exempt sectors. How much certainty can we have in the consequent estimate of, for example, irrecoverable Scottish VAT associated with the financial services sector?

The main limitation of the Paper is that it does not provide any assessment of the confidence intervals likely to be associated with the VAT estimate made using the proposed methodology. For context, the GERS methodology paper states that the 95% confidence interval associated with the GERS estimate of Scottish VAT is +/- £223 million.

But is the proposed methodology associated with a larger or smaller confidence interval? A confidence interval of +/- £200 million would imply that we should expect the Scottish budget to fluctuate by several million pounds each year purely as a result of sampling variability. How much of such variability would be acceptable?

## Annexe B

**Letter from the Convener to the Cabinet Secretary – 25 March 2019**VAT assignment in Scotland

As you are aware, the Committee has taken a keen interest in development of the methodology being used for assigning VAT in Scotland. During our pre-budget and budget scrutiny, we explored how robust the model was and whether there were any potential risks associated with VAT assignment in Scotland.

The Committee concluded that basing VAT assignments for Scotland on estimated figures could introduce further volatility into Scotland's finances and recommended that both Governments should continue to review the methodology used for assigning VAT to Scotland during the implementation year to ensure its robustness and reduce the risk of introducing yet further volatility into the Scottish budget.

These issues were explored further at its meeting on 13 March 2019, where we held a roundtable evidence session and agreed to write to you highlighting the issues raised during discussion. The Official Report and papers for that meeting, including a briefing paper from the Committee's Adviser, can be accessed on the Committee's website—

<https://www.parliament.scot/parliamentarybusiness/CurrentCommittees/101355.aspx>

The Committee were told that the main challenge in assigning VAT was in how to calculate a robust estimate. Witnesses said that the risk to the Scottish Budget from assigning VAT revenues could be increased given the statistical uncertainty inherent in forecasting and estimating VAT receipts in Scotland.

Questions arose around the data sources being used in the model, such as the annual survey in hours and earnings, as opposed to real time information from HMRC. Witnesses said that there is a need for more transparency around these issues and for more detail on the variability in the methodology of the data sources being used in the model. It was also suggested that the sample size being used may be too small and that using information based on one year, as opposed to taking an average over a number of years, could reduce the reliability of the estimates.

We explored the possibility of an alternative model based on actual outturn figures as opposed to estimates however, witnesses were not convinced that this would produce more accurate results and highlighted numerous difficulties associated with setting up a Scottish VAT system including the major administrative burden this would put on Scottish businesses.

The Committee intends to take evidence from you on these issues in May and I would be grateful if you could respond to this letter in advance of that evidence session.

Yours sincerely,

**Bruce Crawford MSP**  
**Convener**