The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

FINANCE COMMITTEE

Wednesday 6 January 2016

Session 4

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FINANCE COMMITTEE
1st Meeting 2016, Session 4

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*John Mason (Glasgow Shettleston) (SNP)

COMMITTEE MEMBERS

*Jackie Baillie (Dumbarton) (Lab)
*Richard Baker (North East Scotland) (Lab)
*Gavin Brown (Lothian) (Con)
*Mark McDonald (Aberdeen Donside) (SNP)
*Jean Urquhart (Highlands and Islands) (Ind)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Robert Chote (Office for Budget Responsibility)
Professor Campbell Leith (Scottish Fiscal Commission)
Lady Susan Rice CBE (Scottish Fiscal Commission)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance Committee

Wednesday 6 January 2016

[The Convener opened the meeting at 09:30]

Decision on Taking Business in Private

The Convener (Kenneth Gibson): Good morning and welcome to the first meeting in 2016 of the Finance Committee of the Scottish Parliament. I wish everyone a happy new year. I remind everyone to turn off any mobile phones, tablets or other electronic devices.

Our first item of business today is to decide whether to consider our work programme in private. Do members agree to do so?

Members *indicated agreement.*

United Kingdom Spending Review

09:30

The Convener: Our second item is to take evidence on the recent United Kingdom spending review from Robert Chote, chairman of the Office for Budget Responsibility. I welcome Mr Chote to the committee and invite him to make a short opening statement.

Robert Chote (Office for Budget Responsibility): Good morning, convener, and thank you for the invitation to speak to the committee. It is a great pleasure to be here—as always. The last time I joined you to discuss the economic and fiscal outlook was—perhaps fittingly—April fools day last year, following the coalition Government's final budget. Since then, we have produced two further forecasts: the first alongside the post-election budget in July and the second alongside the spending review in November. To all intents and purposes, you can think of those as two halves of the same fiscal event. The Conservative Government has used them to depart significantly from the provisional tax and spending plans that they had agreed with the Liberal Democrats in coalition last March, setting out their own preferred strategy for the rest of the Parliament and beyond. In talking about what is in the latest forecast, it is perhaps helpful to contrast with the situation in March, so that we pull together the two elements of what the Government has done.

The first point to make is that neither the underlying forecast for the economy, nor the underlying forecast for the public finances, has changed a great deal over that period. Almost all the action of interest has been in the policy decisions that have been taken and the make-up of the remainder of the post-crisis fiscal repair job.

Back in March, we were predicting that the economy was pretty close to full capacity, that it would grow by about 2 to 2.5 per cent a year over the next five years and that inflation would move relatively slowly back to its 2 per cent target. Effectively, we made the same predictions in November and those are broadly in line with the average views of other forecasters. Those are our central forecasts. History suggests that reality will be less smooth than that, but we think that the fluctuations are as likely to be above those numbers as below them.

Most of the key uncertainties and questions around the economic forecast are pretty much the same as they were in March. When are we going to see a return to sustained robust growth in productivity and wages? How is the economy going to rebalance in response to the continuation of fiscal consolidation? How will the UK respond to global events, such as tighter monetary policy in the United States, lower growth in China and developments in Europe?

Reflecting the recent stability of the economic forecast, the changes in the public finances forecast over the past year have also been relatively small compared with those that we have made in earlier years. Following the autumn statement, many people latched on to the famous £27 billion—over the next five years—that we had apparently found down the back of the sofa. The biggest contributors to that aggregate improvement in the budget balance over the forecast period were a fall in the Government's prospective debt interest payments, the knock-on effects of the recent strength of some tax receipts and some changes to the way in which we forecast VAT and national insurance contributions. Those positive developments were partly offset by the impact of lower share prices on tax revenues, as well as by judgments that we made on the outlook for spending on disability benefits and property transactions.

Unfortunately, £27 billion is not as much as it sounds. Over five years, it corresponds to an average downward revision to the budget deficit of about 0.25 per cent of gross domestic product. That is pretty small beer in an economy where the public sector is spending about 40 per cent of GDP and raising about 36 per cent of GDP in revenue, and where the average error in forecasting the budget deficit at an autumn statement, even over the remainder of the year that you are already in is twice as big, at 0.5 per cent of GDP. If we add in the changes to the forecast that we made in July, which went in the opposite direction, we have an even smaller underlying net improvement in the budget deficit since March, of closer to £10 billion or, cumulatively over five years, of about 0.1 per cent of GDP. Again, that excludes the impact of policy measures.

By way of comparison, if you look at the underlying changes that we have made to our budget deficit forecasts between previous March budgets and autumn statements, we had a deterioration of about 1.5 per cent of GDP in 2011, a deterioration of 1.25 per cent in 2012, an improvement of 0.75 per cent in 2013 and a deterioration of 0.25 per cent in 2014. The lesson from that experience is that what the sofa gives, the sofa can easily take away; the sums lost or gained have often been much larger than they were last November.

Confronted by our relatively modest changes to the underlying economic and fiscal forecast, what policy judgments has the chancellor taken, taking the budget and the autumn statement together? The key decision that he has made has been to reshape the remainder of the fiscal consolidation—the fiscal repair job—to rely less on cuts in public services spending and more on tax increases and welfare cuts than was implied by the coalition's plans in March.

The tax increases and the welfare cuts build up gradually and less quickly than the chancellor said that he was going to aim for ahead of the election, so he has also decided to borrow more over the next three years to reduce the severest squeeze on public services spending in the middle years of the Parliament. He then aims for a slightly bigger surplus in the medium term. Combined with the changes to the underlying forecast, that leads him on course to achieve his objective of getting the budget back into surplus in 2019-20, with about £10 billion to spare. The performance of past official forecasts—ours and the Treasury's—suggests that that corresponds to about a 55 per cent chance of achieving a surplus in that year, on current policy. It is by no means a done deal.

For public services, the two-stage loosening of the belt, as it were, in July and November means that the Government is now looking at a real cut of around £10 billion a year by 2019-20, which is much smaller than the £42 billion a year by 2018-19 that had been pencilled in by the coalition. That corresponds to a real cut in public services spending of about 1.1 per cent a year over this Parliament, compared with 1.6 a year over the previous one. That is smaller, but it is still quite a challenge. A lot of low-hanging fruit has already been plucked and the cuts are obviously much bigger than that average number in those areas of spending that are unprotected.

On the welfare spending side, the Government announced a significant package of welfare spending cuts or cuts in benefits and tax credits back in July, the proceeds of which the chancellor banked when setting his welfare cap—the cap on the cash spending on a large subset of welfare spending. However, by November that cap had already been breached, thanks in part to slower than expected progress on disability benefit reform and in part to the chancellor's decision to reverse the major tax credit cuts that he announced in July. That is costly in the near term, but less so in the longer term, because by then most of the people who will be affected are expected to have moved on to the new universal credit. The universal credit was also reduced significantly in July, but those cuts were not reversed in November.

To wrap up, if you look at the evolution of the forecast since the end of the coalition, the underlying economic and fiscal picture has not changed very much. We expect the economy to grow, but at rates slower than you would expect in a typical economic recovery. We expect the budget to get back in modest surplus over the next five years, with the deficit having now more than halved from its postwar peak. However, as always there are lots of uncertainties in the underlying forecast, not least the outlook for productivity and wage growth and what that means for tax revenues.

It is also important to bear in mind that our forecasts are based on current policy; they are an assessment of the most likely outcome under current policy. Many other forecasters may think that policy might change. Some forecasters would look at the public services cuts and ask whether they can actually be delivered, some would look at the welfare savings and ask whether the Government can deliver the reforms logistically and the cuts politically, and some would say that if there are disappointments on either of those two fronts or on the underlying forecast, that might mean that the Government will rely more on tax increases or will look again at the ambition to be running sustained budget surpluses into the future. There are lots of uncertainties but, fortunately, those policy ones are outside our remit and we can leave them for other people to worry about.

I am happy to take questions on that.

The Convener: Thank you. As always, that was a fascinating introduction. Your executive summary on the economic and fiscal outlook also makes interesting reading.

I know that colleagues have questions to ask, so I will not exploit my position in the chair—they all smirk, but it is true. I will not ask too many initial questions, but I certainly want to touch on a number of areas that I am sure my colleagues will want to delve into in greater depth.

I want to ask about borrowing first. In your introduction, you talked about falling debt interest and payments leading to some of the Government's recent decisions about the money found down the back of the sofa, as you said. Compared with the July forecast, you have revised net borrowing down £0.6 billion to a still quite eye-watering £73.5 billion. In paragraph 1.4, you say:

> "Spending on debt interest is also lower in all years, reflecting a further fall in market interest rates."

What would be the impact of a rise? There has been a rise in interest rates in America. What would be the likely impact on finances if there should be even a modest rise in interest rates?

Robert Chote: You can see the sorts of changes between the July forecast and the November forecast. On average, interest rates or yields move by about 0.4 percentage points. If you look at the aggregate for the five years, you see that that contributes about £17 billion of the famous £27 billion.

In July, those numbers moved somewhat in the opposite direction. If you were looking at an uncertainty where money can come in in one forecast and go out in another, that would be an obvious place to look. It is worth bearing it in mind that we simply take the interest rates that are out there in market prices and apply them. We are not making our own subjective judgment of whether the market is over or underegging the level of interest rates.

If you go back a few years, lots of people were saying that interest rates cannot fall that much lower but they have. To date, we have not seen a big movement in the opposite direction in response to the Fed's move but, obviously, with the new year under way, people are thinking about the outlook for the economy, the expectations for the pace of future interest rate movements in the US and what will flow from that. Things are obviously uncertain and it is one of those areas in which relatively modest movement can make quite a big difference to the fiscal numbers in both directions.

We probably had this conversation a while back and asked whether, given that the interest rate had gone down, it could go down much further. Of course, it has.

The Convener: Will there not be an impact from, say, a 0.25 per cent increase in the interest rate, or indeed a decrease?

Robert Chote: We have a ready reckoner in the outlook. I would dig out the precise link, but I will probably not be able to find it straight away. As I say, a change of about 0.4 percentage points has contributed the change that you can see in the outlook report, so you can scale down to 25 40ths of that.

The Convener: Fair enough.

In discussing GDP growth at 2.4 per cent, you talk about high population growth, an increase in mortality among older people and the fact that higher net inward migration has driven some of that growth. How much of the growth in the economy is per capita? That gives a look at the real underlying strength of the economy and the extent to which it is just growth from the increasing population.

Robert Chote: I can dig the number out. Obviously it depends on whether you are looking at per capita by head of population or working population. The impact of net inward migration increases overall GDP growth as well as the population, but it also increases per capita GDP growth because net inward migrants are more likely to be of working age than the native population on average. It is not the case that such things are simply feeding through into headline GDP for growth but not into per capita GDP.

The Convener: You say:

"we continue to expect employment growth to slow as productivity growth picks up."

We have raised the issue of productivity previously and how we boost productivity is a concern. What change in productivity are we seeing at the moment?

09:45

Robert Chote: We have seen some improvements, although we have had a set of GDP revisions since we published the forecast and we have not had a chance to incorporate it yet. There have been some downward revisions to GDP that might have affected the overall productivity provision. We have seen some quarters of good news in comparison with what has come in the past, but in the forecast we took the judgment that it was too early to assume that the flowers that we can see are representative of a much better outlook.

We continue to assume that productivity growth is picking up and going back towards historical levels, but we and others have made that prediction for some time and it has taken longer than anticipated to happen. As you know, there is a long list of potential explanations of why productivity growth has been as weak as it has, and one that people place a fair amount of emphasis on is that the difficulties in the financial system have got in the way of the efficient allocation of capital away from relatively unproductive firms and towards more productive ones.

Looking at the conditions in the financial system, I think that it is fair to say that things are easier than they were, so it would be a bit of a surprise and somewhat alarming if we were not seeing some signs of good news in response to that. However, we took the view in the forecast that we should not yet assume that we have kicked straight back to more historically average performance and therefore assume a continued slower return. That matters a good deal in the forecast because we assume that improvements in productivity would underpin an improvement in wage growth, and we need a return to robust real-wage growth in order to bring about the growth in income tax receipts that we are looking for.

The Convener: You have just mentioned robust real-wage growth, but in paragraphs 1.3, 1.5 and 1.23 of your outlook, you express concern that the new apprenticeship levy will have an impact on wage growth of about 0.7 per cent. You say that by 2019-20,

"an £8.0 billion increase in total departmental spending is largely offset by a £7.2 billion net tax increase (mostly the new apprenticeship levy and larger rises in council tax)."

You go on to say:

"the ongoing costs of autoenrolment and the introduction of an apprenticeship levy will weigh on earnings growth. These are both economically equivalent to payroll taxes, so ... we assume that most of the cost will ultimately be borne by employees."

You did not really talk about that in your introduction. Will you comment on your thinking on that?

Robert Chote: The view that we have taken of the apprenticeship levy is to think of it, in effect, as a payroll tax. Most of the impact will be felt on wages at the end of the process, although there are uncertainties about the impact of measures such as that one, the minimum wage—although that is more on the employment side than the wages side—and auto-enrolment.

Ultimately, the underlying question of whether there is going to be a return to historically average rates of productivity growth and the wage growth that is associated with that is going to be much more important than the uncertainties around those measures, but we have made an adjustment and it is one of the reasons why we have a somewhat weaker picture for earnings growth and income tax towards the end of the forecast.

One of the reasons why the improvement in the underlying fiscal forecast between July and November is at its biggest in the middle of the Parliament and becomes less towards the end is that we have that weaker view of earnings growth further out, hence the Government having to rely rather more on tax increases towards the end of the forecast period in order to achieve what it wants to achieve on the bottom line of the budget deficit. Our forecast is not helping as much in 2020 as it does in 2018, and the judgment on the apprenticeship levy and earnings growth is part of the explanation.

The Convener: Another issue that you did not touch on in your introduction but which is in your executive summary—at paragraph 1.13—is asset sales. You say:

"asset sales make the difference between debt rising and falling as a share of GDP in 2015-16, with £30 billion expected in the financial year as a whole and £24 billion realised to date."

You go on to say:

"when the Government gives away some of the assets, as with Royal Mail shares and the planned retail offering of Lloyds shares early next year, the sale will raise less than the asset is worth and the public sector's net worth is reduced."

Will you expand on that?

Robert Chote: For some while during the last Parliament, we were forecasting that, on existing policy, the Government was not on course to achieve its old fiscal objective of getting the debt to GDP ratio falling in 2015-16, and for some while the Government had basically said, "Okay—we accept the forecast, but we don't think that it would be sensible to further tighten policy in order to bring that about."

What then happened is that the Government announced a significant programme of asset sales in 2015-16 that is sufficient to bring down the debt to GDP ratio in that year. In subsequent years, the underlying primary budget balance—the budget balance excluding interest payments—has improved to the extent that it gets the debt to GDP ratio falling of its own accord, such that it is not necessary to rely on asset sales in the same way that it is in 2015-16. We wanted to make it very clear to people that that was why the target had come back into play when it had been out of play for some time.

With asset sales, one of the issues that we always address in the forecast is whether we can be sufficiently confident about what the Government is intending to sell, when it is going to sell it and what price it might get for it to put it in the forecast rather than merely cite it as a potential risk or a potential change. In the scrutiny process that we have gone through, we have been very clear with the Government about what level of certainty we need to have on particular sales for us to be willing to include them. That said, there are some uncertainties. For example, we now expect the student loan sales to be later than we did in the forecast that we produced in July.

In relation to your final point on the impact on net worth, a key issue is that, if the Government is selling something for roughly what it is worth, the underlying health of the public finances is not improved as a result—it is simply getting money today instead of a flow of money in the future. There might also be instances in which the Government is deliberately disposing of something for less than its value. The obvious example is giving some shares to the employees as part of a sale of shares. That will bring about a diminution in net worth, other things being equal, but the Government obviously has other policy objectives in doing that. When those sorts of things happen, we feel that it is important to highlight that. When there are such changes in net worth and an asset sale is made up front that will have an implication in reducing revenue many years into the future, it is worth highlighting that to people as one of the consequences of what the Government has done.

The Convener: I want to ask you a couple of questions on devolved taxes, after which I will open up the questioning to colleagues. My first question is on land and buildings transaction tax. When one looks at the OBR's predictions of LBTT revenue, it looks as if there will be huge growth between 2015-16 and 2020-21—it is predicted that the revenue stream will almost double. However, when one looks at what the Scottish Government is predicting, your predictions seem quite moderate. For 2020-21, the difference in revenue appears to be of the order of some £90 million—that includes non-residential and residential transactions.

Could you talk us through how you came to those figures? To me, the predictions of the Scottish Government and the OBR appear to be very ambitious, even taking into account the predicted rise in house prices and the number of transactions over that period.

Robert Chote: Sure. The key reason for much more rapid growth—this will be true of our forecast and that of the Scottish Government—is a combination of house price increases and a continued recovery in the rate of transactions that will bring it closer to its long-term average. That combination will provide a much faster increase in revenues than we would see in income tax or VAT—in other words, taxes on labour, income or spending.

The figures that I have for 2020-21 suggest a difference of about £35 million. I am making a comparison with the forecast in the draft budget—in other words, the Scottish Government's more recent forecast, rather than the one that we use in our report. The Scottish Government's forecast is about £70 million higher than ours on the residential side and about £36 million lower on the non-residential side. Overall, the Scottish Government's forecast is about £35 million higher.

On the residential front, the difference is explained by three factors. The Scottish Government is assuming slightly more rapid increases in house prices over the period—about 28 per cent in aggregate between 2015-16 and 2020-21, whereas we have about 26 per cent.

The Scottish Government has a 15 per cent increase in transactions between 2015-16 and 2020-21; we have about 9 per cent. The Scottish Government's transactions forecast, as I understand it—commission colleagues will correct me if I am wrong—is based on reaching a long-run average of a 6 per cent rate of transactions compared with the size of the housing stock. That is the average recorded between 1995 and 2014.

In our July forecast and earlier forecasts, we were using a similar approach. We assumed that UK transactions reverted to their rate from 1991 to 2004 on average. However, in this most recent forecast, we drew on research that suggested that more of the housing stock is buy to let and buy-to-let properties tend to be bought and sold less frequently than owner-occupied or other properties. We therefore adjusted the forecast down slightly. I suspect that that may be one element in explaining the difference.

The uncertainty around transactions means that the difference between our forecast and the Scottish Government forecast is small compared with the uncertainty that lies around both of them. It is partly because the Scottish Government has taken a slightly more optimistic view of prices and a more optimistic view of transactions.

The modelling approaches that we use are also slightly different. It may be that the Scottish Government uses a technique that we have been anxious about using in the UK context because we have more of a problem with the importance of very high-value properties in London and elsewhere. There may be a difference in the implied number of relatively high-value properties in each of our two forecasts. However, as I say, I would not regard the difference between the two as being large compared with the uncertainty that lies around either of the forecasts in isolation.

The Convener: Thank you for that comprehensive response. There was so much scurrying about because we were just checking that we were comparing apples with apples rather than apples with oranges in terms of the figures.

Robert Chote: It is never entirely clear which year we are looking at and which comparison—

The Convener: I did say that I would ask a couple of questions but I am actually going to ask three—I have just two more, honestly, folks, so I ask for your patience.

As regards the block grant adjustment mechanism, the draft budget says:

> "Until a permanent agreement is reached ... the Scottish and UK Governments have agreed a provisional one-year block grant adjustment for the fully devolved taxes in 2016-17 of £600 million."

There is no further information in the draft budget on the basis of the figure and how it was arrived at. Is it reasonable or perhaps slightly high or slightly low?

Robert Chote: I think that you are taking me beyond my remit. These are deep and treacherous waters, convener.

The Convener: One can but try.

Robert Chote: We simply provide the numbers and it is for others to put them through the political mill and reach policy conclusions from them.

The Convener: Fair enough—I will not press you on that.

My last question at this point is about landfill tax. You have significantly changed your revenue forecast on landfill tax from July last year and the current financial year from £94 million to £140 million. Indeed, over the next few years, up to 2020-21, the figures that you are forecasting go down from £140 million to £120 million and then back up to £140 million. Those figures are substantially different from the Scottish Government's figures.

In proportionate terms, the Scottish Government predicts that for 2016-17, the revenue from landfill tax will be £133 million as opposed to your own figure of £131 million. The Scottish Government then predicts that the revenue will go down steadily year on year, from £123 million, to £114 million, to £104 million and then to £94 million in 2020-21.

Why are you at such odds with the Scottish Government on that forecast? Why is there a dip then an increase in predicted landfill tax revenues and why does the divergence seem to grow year on year?

10:00

Robert Chote: The uneven pattern is due to the interaction of what we assume about the volume of landfill and movements in inflation over the period. The reason why our numbers are considerably higher than the Scottish Government's is that the Scottish Government is basing its forecasts on the assumption that its landfill targets will be achieved. Our forecast is based on current policy rather than current policy ambitions. If we had evidence that there were policies in place to deliver those ambitions, we would be inclined to incorporate those sorts of effects.

I note that the Fiscal Commission's comment on that is that it was

> "broadly satisfied that there are potential policies which could feasibly deliver the target which underpins the forecast".

The key word there is "potential". There is a methodological difference rather than a disagreement. We would incorporate the impact of policies that had been announced and that we were persuaded were going to deliver, whereas the Government, perfectly reasonably, has produced a forecast on the basis that the objectives will be achieved. The commission says that it thinks that there are policies that could do that, but they have not yet been implemented. If they were implemented, then I would expect the numbers to get closer together.

The Convener: Thank you very much for that.

I will now open out the session. The first of my colleagues to ask questions will be Mark McDonald, followed by Gavin Brown.

Mark McDonald (Aberdeen Donside) (SNP): Thank you very much, convener. Good morning, Mr Chote.

I want to delve a little bit more into the £27 billion. I was intrigued when you said that that is not that big a number: I would not say no to it, but I can see the point that you were making. I want to test the vulnerability of that figure.

The convener focused, quite rightly, on the impact of interest and on the impact that an interest rate change would have. We have seen that movement in America and that will obviously set the hares running globally.

What is the vulnerability of the forecasts for tax receipts, VAT and national insurance over the piece? How robust will those be over the period that the £27 billion is realised?

Robert Chote: There are considerable uncertainties around most of the forecasts. I will look, in particular, at what you might think of as the two modelling changes that we have made. One is in the VAT forecast, where the problem is that we have underestimated the amount of VAT receipts by a particular route, in that there are deductions from VAT that partly reflect the fact that there are transactions that take place within Government that, at the end of the day, do not generate money for the Exchequer, because you are taking with one hand and giving back with the other.

Probably since before we were around, the forecast models for VAT have assumed that VAT reductions essentially move in line with their historical trend. The problem is that that works okay if public expenditure moves on a relatively straight line. However, if there is a period in which public expenditure falls, then the amount of VAT deductions arising from VAT refunds is lower than expected and therefore the receipts end up being underestimated. That is a long-standing and relatively untransparent model. We identified that that is a mistake in the model that would not become apparent until there was a clear change in the direction of public expenditure. There is a change, so we have corrected that mistake and the model will, I hope, produce a better forecast for the VAT refunds.

We have also been anxious, for some time, about how to model national insurance contributions. For historical reasons, NICs have been forecast using a model produced by the Government Actuary's Department that is quite untransparent and hard to reconcile with the income tax forecast. There would, for example, be movements in earnings that did not generate the sorts of changes in the NICs forecast that might have been anticipated.

We have said that we will now forecast NICs on the same basis that we forecast income tax, so that there is a comparable model that is more transparent. We should also be able to better check that what is going on in the income tax forecast is consistent with what is going on in the NICs forecast. That has the effect of making that change. It boosts things, probably because there is a more accurate picture of the amount of national insurance contributions being paid above the upper earnings limit on relatively high earnings. We think that that is a bit better.

Those are methodological changes addressing what we think will be sources of on-going error in the rest of the forecast. Of course, there are uncertainties around those.

Obviously, a lot of other things are moving within the £27 billion or within the changes and the underlying deficit forecast, as you mentioned. As the convener said, there is debt interest, which, given how we do the forecast, will simply move in response to movements in market rates. The largest negative element that we have subtracted was the movement in equity prices between July and November 2015. When equity prices are weaker than anticipated, money is lost from taxes such as capital gains tax and inheritance tax. Equity prices may change, so we make a relatively simple assumption about share prices moving in line with the cash size of the economy. That is an obvious source of uncertainty, too.

The Bank of England has suggested that it will start reversing quantitative easing a bit earlier than it otherwise would have done, which is another change. That will produce debt interest savings.

There are also uncertainties around particular sets of receipts coming in stronger or weaker. Most of the big taxes came in a bit stronger than anticipated in November 2015 relative to July 2015. There was a decision about whether that was new news or temporary good news that will go away again, so the issue is about how much that change is pushed through into future years of the forecast.

As I said, you have only to look at the size of the equivalent changes between previous budgets and autumn statements to see that what the sofa gives, the sofa can take away. Obviously, it is for the chancellor to decide, knowing that those uncertainties are there, how much room for manoeuvre he wants to put into his policy plans to achieve the objectives and formal and informal targets that he has set himself.

Mark McDonald: I noted that, in the OBR report, you have suggested that the "giveaways", as you have called them, amount to around £18.7

billion. Obviously, that is less than £27 billion, but it is still a substantial amount. Given what you have outlined here, there are a number of uncertainties around the robustness of the £27 billion figure. It strikes me that it would not take a lot to happen for that figure to diminish significantly, depending on the changes that take place over the period. That would lead to concerns that, even if there were a reduction, the reduction could go beyond the apparent cushion between the £18.7 billion and the £27 billion.

You have mentioned a number of areas where delays in policy initiatives, particularly around welfare, led to money that would not have otherwise been made available had those initiatives been followed through. For example, you referred to the slow progress on disability benefit reform. Some people will be quite glad that that has not progressed as quickly as it was projected to. Assuming that progress on that reform were to pick up, would that have an impact on the projections or is that possibility factored in?

Robert Chote: I will pick up your first point to begin with. The one thing to bear in mind with the comparison of the aggregate giveaway versus the aggregate improvement in the underlying forecast over the period is that, under normal circumstances, one thinks of an improvement or a deterioration in the forecast getting bigger over time. For example, there may be a policy giveaway or a takeaway that gets bigger over time, so what is going on in year 5 is like what is going on in year 2, only more so.

Both for November 2015 and July 2015 that was not the case. There was no deterioration or improvement that got larger over time; rather, there was a relatively small improvement in the underlying public finances forecast that was focused in the middle years of a session, and which therefore ebbed away towards the end. Equivalently, the policy giveaway was front loaded. In a sense, the Government will give away about £6 billion next year in additional public services and welfare spending by reversing the major tax credit cuts. However, it is no longer doing a giveaway at the end of the forecast, because the public services spending increases are smaller and the welfare giveaway that we had to begin with will have ebbed away because, by then, most people will be on universal credit.

Therefore, the impact of the forecast changes and the policy is more substantive in the middle years of the Parliament than it is towards the end. The chancellor's objectives for where he wants to be are slightly less vulnerable to all that at the end of a Parliament than in the middle years because there is more going on in the near term than there is towards the end.

Mark McDonald: I get that, but does that mean that, if there is front loading of spend and if the vulnerabilities were to be realised, there would be a steeper cliff face? If, for example, the £27 billion of revenues that you expect around the middle of the Parliament were not realised for whatever reason—be it that interest rates are moved up or that the vulnerabilities that you mentioned on tax receipts and national insurance contributions materialise—will that make the cliff face a bit steeper because the spend has been front loaded rather than spread across the piece?

Robert Chote: It could certainly affect the profile of the borrowing. Some of the uncertainties, such as a change in interest rates or movements in share prices, are probably less likely to have the same lumpy profile in terms of adjusting the forecast and might have more effect at the end than in the middle. It would change the way in which borrowing moves over time and we might find that a positive or negative surprise shows up proportionally more at the end of the forecast than in the middle or in what is visible now from what happened between July and November.

If there are movements in those things, it is for the Government to decide whether and to what degree it wants to change policy to affect the profile of the deficit through the next five years or whether it is really focused on where it is in 2019-20, when it has a target to be in surplus, or thereafter. The overall policy changes that were made between March and July show that the Government has been willing to borrow more in the middle years of the Parliament but is still aiming for a slightly bigger surplus towards the end. It has been willing to let the deficit take the strain in the middle but is not going for a looser position towards the end. It will have to make such judgments every time there are changes in the forecast.

Mark McDonald: The point that I was making is that, if the bump that was expected as a result of that £27 billion uplift is in any way deflated below the levels of input that the chancellor is making in the front loading and tapering that you mentioned—I would not suggest that it would completely fail to materialise—it could lead to him standing up mid-term and saying that he has to borrow more or cut more deeply to make up for the £27 billion that he expected but that will not materialise.

Robert Chote: If the improvements in revenues in the middle period do not materialise to the degree that is anticipated in the forecast, he has a choice about whether he responds to that by finding some revenue from somewhere else through tax increases, cutting spending, which could be in public services or welfare, or borrowing more. Between March and November, he showed himself willing to borrow more in the intervening years to make the toughest of the squeeze on public services less tough when he has not raised sufficient money from tax increases and welfare cuts on their own to do that, so he might do that.

There are different choices depending on whether he changes policy to affect the middle years of the forecast or is focused primarily on the fact that he has a target to get a surplus in 2020 and a revealed preference for having something like a £10 billion surplus in that year. He can respond to those choices in different ways. There is nothing automatic about responding in a particular way if there is a particular weakness in revenues in the middle of the Parliament.

The chancellor has his formal targets, but he also has what he wants to see the rest of the profile of the deficit looking like. There are many ways in which he could respond to that. There is no definite requirement that, if there is a weakness there, he has to go back and revisit the spending plans, for example. They are now pretty much inked in through the remainder of this Parliament.

10:15

History suggests that it is not impossible to go back and change those plans, but they are not like a normal budget or an autumn statement. We know that another one of those is coming around the corner and things can be tweaked again in the same way. There are slightly longer-term consequences, as spending plans for departments over that period are inked in, so the stakes are somewhat higher. However, as I said, plenty of responses could be made on the spending side or the receipt side.

Mark McDonald: The question that I initially asked—before I sidetracked you—was about the initial slow progress on some welfare reforms and whether they will pick up pace or be implemented effectively over the next Parliament. We will leave aside the ideological differences that exist. What impact, if any, will that that have on the projections? Has it been factored in?

Robert Chote: One of the reasons why we pushed up the forecast for disability benefit spending is that there is a money-saving reform that is designed to move people to a less expensive system. However, reassessment of people in moving from the initial system to the later system is not going as quickly as expected. There are also changes that are related to the proportion of people who are expected to succeed in receiving the new variant of the benefit. There may be changes in the case load in respect of the number of people who apply. If a money-saving reform is going less quickly than expected, that is obviously an upward pressure on spending. If it ends up moving more quickly than expected and saves the amount that is expected per person in moving from the old regime to the new regime, the deterioration, or forecast, could move in the other direction.

There is a separate set of forecast changes due to the fact that the roll-out of the new universal credit benefit, to which people will move over the longer term, has been pushed further out into the future. In most of the forecast changes that we have done, that does not cost the Government money; rather, it saves it money because, in the original plan, the universal credit system was going to be a more expensive and generous system than the one that it replaced. However, the difference has narrowed as changes have been made to the future generosity of universal credit.

We have been struck that that is following the same pattern as we saw with changes to incapacity benefit. Recent history suggests that such reforms do not move as quickly, and do not save as much money as fast as the Government had hoped. Our forecasts have reflected that, so we have ended up pushing up our spending forecasts. Each time we look at the matter, we try to not get ahead of that, but instead to get the right way and to respond adequately. There remains uncertainty, which we have flagged up.

Mark McDonald: Finally, I want to follow on from the convener's questions about LBTT forecasting. Obviously, you have made a significant downward revision of your initial forecast, and that has been done in a staged way. I think that you have reduced your forecast on more than one occasion, and it now seems to be more in line with what the Scottish Government predicted. However, you seemed to indicate that you are not using the same method as the Scottish Government uses to make the forecast. Why was your LBTT forecast much more optimistic initially but is now moving towards being more in line with what the Scottish Government predicts, if you are not using the same method?

Robert Chote: The reason for the reduction in the forecast is primarily a story about the UK as a whole, rather than about Scotland relative to the rest of the UK. It comes back in part to the judgment that we made that transactions will not increase as much over the five years as we anticipated originally. We took on the evidence that there is a higher proportion of buy-to-let properties, which are likely to turn over less frequently than they did previously. We assume that that applies in both cases.

The Scottish Government has a stronger forecast for transactions for residential LBTT and a slightly stronger forecast for prices. I suspect that, despite the difference in methods, things are going in the same direction, and I do not think that that methodological difference is statistically significant, by any means. As I said, it is not a disagreement; we do not think that the Scottish Government method is wrong. Its process uses what is called a log-normal distribution—which academic colleagues will be able to explain more correctly and in much greater detail than I can—to fit a distribution, which it then moves. We use microsimulation—a more detailed picture of the distribution of house prices—then move that forward.

The difficulty of using the Scottish Government method in the UK context is that it would not put enough weight on what is going on with relatively high-value properties. For the UK as a whole, what is going on with very high-value properties, particularly in London, is much more important to the forecast. We have seen weakness in stamp duty receipts reflecting a fall in the number of properties that are sold at £2 million plus. There are not many of those, but they account for quite a large chunk of stamp duty receipts. I would not place too much emphasis on differences in methods as a source of major differences in forecasts.

As I said, the difference between the two forecasts now and beforehand is not significant relative to the uncertainty around either of them. The primary source of uncertainty is probably what goes on with transactions in aggregate.

Mark McDonald: The UK Government will use your forecast as its basis for discussions on block grant adjustment, which is why I wondered about the change. We had a big discussion about the block grant adjustment in the initial stages of LBTT coming into effect. Anything that could prevent such wide disparity in the future would be welcomed.

Robert Chote: We have a good relationship with the Scottish Fiscal Commission. We have regular discussions with the Scottish Government and although the Fiscal Commission is not in the room for them, it is there electronically. At those meetings we discuss with HM Revenue & Customs our pre-measures forecast in each round, and we ask whether there is particular information or interpretations of recent outturn data that we should take on board.

I can confirm that we would certainly not make any methodology decisions based on what consequences they might have for a discussion on the block grant. We are producing the best forecasts that we can, based on our professional judgment, and it is for the UK Government and the Scottish Government to use or misuse them as they see fit.

Gavin Brown (Lothian) (Con): Good morning. You provided your “Economic and fiscal outlook November 2015” at the tail end of November. Has anything significant happened since then that would give you a different result if you were writing the same report today?

Robert Chote: We have not gone through things that way, so it is hard to give a firm answer to that question. We have had some GDP revisions after looking at what has happened to GDP growth in the past—the Office for National Statistics has shown a slower growth picture. We will have to take that into account, but it is not something that typically makes a big difference to our assessment of how much spare capacity there is in the economy, because we assume that it is a revision to both the potential of the economy and its actual level of activity.

Of the key things that could move by the time that we get to the next forecast in March, always the most important between the autumn statement and the budget is what we get in self-assessment income tax and some other receipts in January and February.

Some people were surprised that we did not revise up our forecast for the deficit this year by more than we did. We actually reduced it slightly, leaving aside the issue of the new treatment of housing associations. We think that there are good reasons to expect the deficit to look better in the first quarter of this calendar year than it did in the same quarter last year, relative to the previous three quarters. There are a few reasons for that. One is that past policy changes that should boost self-assessment income will show up in January and February. Another is that the change in the UK’s stamp duty regime was implemented in December and there will therefore be different impacts in the pre-December and post-December periods. Another reason is the announcement by the UK Government in June of some in-year public expenditure cuts, which have not shown up in the numbers yet. If they are delivered, we expect that to improve the numbers.

There are also a relatively small number of tax receipts that the ONS has said it will include in the official measures of receipts. It has not yet done so, but we have included them in the forecast because we are trying to forecast the numbers as the ONS will eventually define them. For all those reasons, we think that there should be a bigger improvement in the budget deficit in the fourth quarter of the fiscal year compared to the same quarter last year, relative to the previous three quarters. However, there are big uncertainties; I cite the uncertainty about how much will come in through self assessment as a key one for the January and February period. The situation is further complicated by the fact that there are policy changes that affect it, as well as what has happened with financial sector bonuses, which also have an impact.

Gavin Brown: I want to move on to the devolved taxes forecast, which you have had a couple of questions on already.

My first question concerns income tax. On page 11 of your document, you project a fairly steady increase in income tax, which I suppose is linked to growth in the economy, in wages and so on. You then make the point that the Scottish share of income tax is on a downward trend—table 2.3 on page 11 shows what is happening between 2012-13 and 2020-21. From 2013-14 to 2020-21, it goes from 2.91 per cent to 2.87 per cent, which is a fairly consistent drop. However, in the single year from 2012-13 to 2013-14, there is quite a big jump—it is seven times bigger than any of the other drops. Do you know what caused that? If that jump occurred every year, it would be extremely alarming.

Robert Chote: The data for 2012-13 became available only in January 2015. Because the information is based on the survey of personal incomes—SPI—it comes in after a considerable lag. Fortunately, that lag will go once people are flagged as Scottish or non-Scottish taxpayers. The main reasons why you see changes in the share is that you have had a series of policy changes that are, in effect, giveaways at the relatively low income levels—particularly the increases in the personal allowance—and there have been, on the other hand, measures that increase the income tax that is paid at the top end. Because of the differences in income distribution between Scotland and the rest of the UK, policy measures that are a giveaway at the bottom and a takeaway at the top are likely to shift the Scottish share down, because fewer people pay the increases and more people benefit from the reductions. Therefore, I presume that what happened in the figures between 2012-13 and 2013-14 is because of the concentration of such measures in that year, although I cannot remember precisely which ones took effect in that year.

Gavin Brown: Will you get the official data for 2013-14 this month at some point?

Robert Chote: We will certainly get it between now and the time when we do the next forecast. At that point, we will have another year of SPI data and another estimate of the share. It is important to bear it in mind that because it is a survey, there is going to be uncertainty about whether that information is captured. The movement in the share between any two years might be affected by the fact that the survey gives us a slightly higher measure in year 1 and a slightly lower measure in year 2. There will therefore be some additional volatility, which we hope will be removed once we no longer have to rely on the SPI to give us shares, and we are relying instead on HMRC flagging people.

10:30

Gavin Brown: That is helpful. Thank you. Moving on to LBTT, the convener has asked you already about some of the disparities between the OBR's projections and the Scottish Government's projections, and you have given a number of answers pointing to slightly higher house prices over time, quite a big difference in transaction forecasts over time and different treatment of the buy-to-let sector. I guess that explains what happens over the course of the forecast period.

If we look specifically at next year—2016-17—you say in table 3.3 that for the next financial year residential LBTT will be £253 million, whereas the Scottish Government says that the figure will be £295 million. I understand that by the end of the forecast period the factors that you referred to would have come into play, which would explain the disparity. However, is there an obvious explanation for why there is a difference of £42 million just for the next financial year for residential LBTT?

Robert Chote: The difference might reflect the most recent outturn data that each of us had available at the time we were doing the forecast, and how much of that we pushed through into future years so that we could have a baseline difference. The size of the difference differs if we have the variants moving in different directions; that is one possible explanation for the difference between our figures and those of the Scottish Government.

I do not know whether the differences that we have in the amount of assumed forestalling will be having an impact by 2016-17 or whether that is mostly showing up as a 2015-16 story. I think that we have a higher number for forestalling than the Scottish Government has for residential LBTT, and I think that we also have one that the Scottish Government does not have for non-residential LBTT. That, too, might affect the year-on-year comparison. The difference might well be because we are working from different starting data in terms of what is coming in through the year, and pushing that through the rest of the forecast.

Gavin Brown: Thank you. You gave explanations about the differences over time for residential LBTT. However, in terms of non-residential LBTT, I guess the position is reversed in a way, because the Scottish Government is less optimistic than the OBR is for next year. Your projection for non-residential LBTT for next year is £243 million, but the Scottish Government's projection is £220 million. Over each of the next five years, you are predicting more than the

Scottish Government is for non-residential LBTT. Are you able to explain the difference between the figures? Are you taking different approaches?

Robert Chote: Again, there are somewhat different methods used. I think that the Scottish Government uses our determinants to drive its forecast, but the starting point is a three-year average of the outturns rather than the latest year. Because the OBR is using a microsimulation model, we use a single base year of 2013-14, then ask how that would look if we pushed it forward into the future. That is a difference, but I am not entirely clear how much it explains the difference between the Scottish Government's forecast and ours. Scottish Fiscal Commission colleagues might have a view on that.

Gavin Brown: Okay. Just to be clear: you are using a base year but the Scottish Government is using a three-year average.

Robert Chote: That is right. With such forecasts we always have to choose whether we want something that is more stable or something that is more timely. There is no right answer to that, but given the techniques that are involved in a microsimulation approach, it is likely that we will lean in that direction.

Gavin Brown: Thank you. Questions on the landfill tax have been dealt with, so I will move away from the paper on devolved taxes and go back to your executive summary of your general economic outlook. Again, a number of questions on that have been dealt with already, but I have a couple of questions regarding table 1.1, which takes up most of page 12 of your summary.

Under the heading "Expenditure components of GDP", the third component is "Business investment". We can see, with 2014 as the starting point, that the figure goes up from 4.6 per cent to 6.1 per cent and then to 7.4 per cent, so we are clearly seeing fairly consistent and healthy growth of business investment.

When we get to 2020, however, we see that there will be a pretty sharp fall back down to 4.5 per cent, which is smaller growth than we saw in 2014. What will happen in 2020 to business investment?

Robert Chote: I suspect that that is a consequence of the changes in the public expenditure plans. In the past year, the Government introduced a sharp increase in public sector capital investment, but there has been less of an increase in the overall public services spending. The figure may be a result of the fact that you start with a path for GDP as a whole, and then, if there are movements in the composition of the fiscal giveaway and takeaway in that year, you would assume that, because 2020 is right at the end of the forecast, that will come out in the wash in terms of the overall impact on the growth rate of the whole economy. The Bank of England will take that into account in setting interest rates, but would not take into account changes that happened in the very near term. It would change the composition. If there is more going on in the public sector at that level than you have had in the previous forecast, you are, in order to get everything to add up, making movements in the other elements. I suspect that that is the case, rather than the particular view that there is something that businesses need to be terribly worried about as we move into spring 2019.

Gavin Brown: Thank you. My last question also refers to table 1.1, slightly further down under the heading "Inflation" and the sub-heading "CPI". Are the figures that you have set down Bank of England projections or your projections for the consumer prices index?

Robert Chote: They are our projections for CPI. We still, in effect, assume that the Bank of England is aiming to achieve, at the end, the inflation target of 2 per cent that it has been given. We have inflation returning to target slightly more quickly than we did back in July; that is partly because of greater assumed pressure from unit labour costs pushing those projections up.

The Bank of England—if memory serves me right—has inflation returning to target somewhat more quickly than we do. However, if you look at the differences, you will see that we are talking about a tenth of a percentage point below the inflation target, so again I would not overstate the significance of any differences there. Those are our numbers. We take the market's assumption of what is going to happen to interest but we do our own forecast for inflation.

Jackie Baillie (Dumbarton) (Lab): As ever, most of the questions have been asked, but nevertheless—seeing as you are here, Mr Chote—I will go through some of the detail. I am absolutely clear on what you are saying about the Scottish share in tax revenues declining as a result of there being fewer higher-rate taxpayers and of changes being made regarding policy decisions.

Is there anything else underlying that? I am conscious that the employment and unemployment rates are different, and that there is population decline in Scotland whereas the population across the UK is expected to increase. I wonder how those other factors might come into play.

Robert Chote: You are right that there are such differences between the employment and unemployment rates. What would matter in terms of the share would be whether the size of those differences changed very much over time. If the relationship between those things is relatively stable, even if they are different, the share will not move around a great deal, so that is not an important driver of what is going on with the share and the forecast. We are not making any implicit or explicit assumptions that the performance of the Scottish labour market relative to the performance of the labour market in the rest of the UK is materially different.

Jackie Baillie: What about Scottish GDP levels relative to UK GDP levels? What are your predictions for those, or do you not do that at all?

Robert Chote: We disaggregate our forecast for the economy by different types of spending and different types of income, but we do not disaggregate it geographically or by different industrial sectors. Other forecasters do that, but it is complicated enough to do it in the way that we have to do it.

An issue that has come up before in discussions of the Fiscal Commission's job, our job and on what one should base the Scottish GDP is the availability and timeliness of the data needed to produce a full-blown Scottish macroeconomic forecast. It is more difficult to do that than to produce one for the UK as a whole, and the task of simultaneously producing a Scottish forecast that is consistent with the UK forecast is greater still. Therefore, we have not made any explicit or implicit judgment about the relative performances of Scottish GDP and rest-of-the-UK GDP over the forecast.

Jackie Baillie: That might be of interest as we move forward.

As a side issue in your report, you talk about the reclassification of housing associations. You may be aware that we have had discussions with Eurostat and the ONS about the classification of private and public sector capital projects. Is that on your radar, or would it be more properly considered by the Scottish Government? It will have an impact.

Robert Chote: It is not something that I am aware of. However, if you think that we should be aware of it—my colleagues may well be aware of it—I would be happy to look at it.

The housing association stuff that you mention underlines the fact that what Eurostat says is appropriate matters as much as what the domestic authorities say is appropriate. Often, such changes are a reflection of the interpretation and implementation of rules that come up at the European level. We warned people about the reclassification of housing associations back in July, because the decision to reclassify is based on where control is effectively exercised rather than on ownership and because the Government was, in effect, telling housing associations what rents to set among other things. We warned that the ONS might want to look at that and, indeed, it has. The Government has said that it wants to undertake a liberalisation that would move things back in the other direction, but we have not assumed that in our forecast. If the ONS indicates that the Government has done enough to make that a likely outcome, we will address that. However, for the time being, we are assuming that the housing associations will stay in the public sector for the duration of the forecast.

Jackie Baillie: Can you tell us the order of magnitude of the impact that that will have on the budget and on public sector borrowing? We are grappling with the same issues here. Classification is at the heart of this, and discussions with the ONS continue. What are the consequences of having housing associations reclassified as a public sector project? I do not think that those are fully understood.

Robert Chote: On the housing association side, it has pushed up both net borrowing and net debt. Net borrowing has increased by about £4 billion or so, diminishing over time, and the net debt change is about £60 billion, or 3 to 4 per cent of GDP. The business model, as it were, for housing associations is their grant income and their trying to run an operating surplus on the properties that they own. They then leverage their income by borrowing in order to build more houses.

One reason why we have seen the impact on the deficit declining over time is that the decision to restrict rent increases, which means less income for housing associations and less ability for them to leverage and to borrow more, has had less impact on the budget deficit. In addition to changing the rents that housing associations are able to charge, the Government restructured the grants to housing associations quite a lot in the autumn statement so that they are lower to begin with, higher towards the end of the forecast and skewed more to shared ownership than to standard social housing. One of the uncertainties surrounding this new element of the forecast is that the Government is, in a sense, trying to push housing associations towards a new business model that is different from the one that they probably thought that they were pursuing. It remains to be seen how willing or able they are to be pushed in that direction, and that will feed back into the size of the changes.

10:45

Jackie Baillie: That is helpful. Although in a different context, we face similar discussions and issues.

I move on to the devolved taxes. There was criticism of your being overoptimistic at the beginning of the process. I am curious, because you are now less optimistic than the Scottish Government. What happened in between? I heard what you said on the assumptions made about prices—

Robert Chote: That is exactly the pattern that we would expect to see over time. If one of us is more optimistic than the other continuously, there would probably be more for you to be concerned about.

Jackie Baillie: I look forward to you both being on the same page—that will be interesting.

You said that the Scottish Government had made assumptions about prices and the number of transactions that are greater than suggested by your model. Would that be fair?

Robert Chote: That is right. As I said, the transactions difference is larger than the prices difference. The Scottish Government is basically taking an approach—we have taken it for some time, too—of assuming that transactions will get back to a historical average. We wrestled with the matter before it became an issue when LBTT became a separate tax. Over time, we have seen changes in housing tenure and a big reduction in housing transactions relative to what we saw prior to the crisis. In those circumstances, a big challenge in producing a forecast is what the medium-term new normal will be to which you think you will be returning. Obviously, there would be a lot of uncertainty about that and both we and the Scottish Government have to make judgments about it. As I said, a difference at the moment might be that we have explicitly assumed that the normal level of transactions to which you will return will be lower than the level that we had assumed in July, because we took on board the evidence that if there were more buy-to-let properties, they would be bought and sold less frequently.

In this area, the challenge in reaching a judgment on who does the better forecasts is the length of time that would be needed to distinguish between luck and judgment when so much is dependent on the level of transactions. In the UK context, an awful lot also depends on the relative movement of high-value to low-value properties. That would be an issue in Scotland, too, but not to the same extent because a smaller proportion of the revenue comes from relatively high-value properties. Transactions are probably the larger issue, but in any event I would not put a great deal of faith in anyone’s firm forecasts for transactions.

Jackie Baillie: The one thing that we have discovered is that people’s behaviour cannot be accounted for; I am sure that we will pursue that issue with the Scottish Fiscal Commission shortly. The degree of forestalling that we saw exceeded your estimates. I think that it exceeded the Scottish Government’s estimates, too. Indeed, it was only when data was available that we were able to estimate that. To what extent do you try to model for people’s behavioural responses to tax changes? I do not think that we do that to any great degree yet in Scotland.

Robert Chote: We always try to do that because, as you said, it can be surprising how big the numbers can get. In the UK context, the classic case was the movement in the higher rate of income tax from 40 to 50 to 45 per cent. We are dealing with a part of the population that is able to manage its financial affairs and move its income from year to year, so if such announcements are pre-announced the sums of money that are moved over those periods are enormous, which makes the task of working out the underlying behaviour of income tax over those periods extremely difficult. That is still being debated now.

On LBTT, we have raised our estimate of the amount of forestalling from £20 million to £30 million. Fiscal Commission colleagues will correct me if I am wrong, but I think that the Scottish Government’s range was from £12 million to £37 million, and it initially thought that the amount would be towards the lower end of that. I think that the commission’s report on the draft budget, if I read it correctly, was pointing at a level in the low £30 millions. However, I may have misinterpreted that, so please check. We also have £10 million of forestalling effect in the non-residential forecast. I do not know whether the Scottish Government has such an estimate at all.

There is a separate issue about whether the move to LBTT and the higher rates at the top will have an impact on behaviour in the long term above and beyond what goes on with forestalling. There, we assume that the higher average tax rates towards the top will lead to fewer transactions and have an impact on prices as well. We incorporate those effects and explain the numbers that we have used, but again the uncertainty around them is significant.

Jackie Baillie: Is the £30 million forestalling figure that you have arrived at the final figure, or is there likely to be further discussion?

Robert Chote: I do not know about further discussion. More data will certainly come in over time. What we have is our best estimate. This is a much larger and more difficult example, but on the income tax rates, we go back and look at our forecasts after a few years and interpret what was going on in the underlying picture and therefore the unexplained bit that is best explained by what was going on with forestalling. That can change well after the event, so I would be surprised if this was the last word—or the last number—on the subject.

The Convener: Thank you, and I thank committee members for their questions. I have a couple of further questions before we wind up the session. On resource departmental expenditure limits, you say in your executive summary, in paragraph 1.36:

> "Taking account of expected underspending against the Government's plans, we expect RDEL spending to be cut by £10.4 billion in real terms by 2019-20."

What is the expected underspend?

Robert Chote: It is a relatively small number. With departmental expenditure limits, the clue is in the name—they are limits that the Government sets in aggregate on spending, and historically, even when public expenditure is rising quite rapidly, departments and the Treasury tend to come in below those numbers. The departments know that the Treasury is standing there with a big stick and the Treasury is obviously keen to ensure that the limits are kept to.

Historically, we have had relatively large underspends such as £6 billion a year. Further out, the numbers are typically in the range of £3 billion to £4 billion a year. I can probably find precise numbers for you later, but they are usually in the low single-digit billions.

The Convener: We are allowed up to 0.6 per cent of resource and 1.5 per cent of capital. I just wondered what the scale was, because you specifically mention that you expect it to impact on the resource limits.

Robert Chote: In the table on page 127, we show the assumed underspending against the limits in each year of the forecast. In 2016-17, we assume underspends of £1 billion on current spending and £2 billion on capital. By 2020, the figures are £1.5 billion on current spending and £4 billion on capital.

The Convener: Thanks for that. We will find out over time the accuracy of your forecasts relative to the Scottish Government's by looking back at what was forecast and the outturn figures.

Robert Chote: We will all be dead before we have a firm answer to that. [*Laughter*.]

The Convener: You have morbidly reported that older people are tending to pass away in greater numbers, but you are not in that category yet, so you should not be too pessimistic.

To what extent are your forecasts for the devolved taxes based on the available outturn data?

Robert Chote: Each time we come to do a forecast, the latest available outturn data is an important input. Typically, we look at how it compares with the forecast for the year as a whole and what that implies will need to happen over the remainder of the year for the original forecast to look sensible. It is helpful when that data is relatively timely and frequent. I think that there are monthly numbers for LBTT, whereas the data on landfill tax is less frequent and we have less to go on. It is always an important input.

It comes down to our job and the Scottish Fiscal Commission's job in judging reasonableness. Each time we come to do a forecast, there are broad questions of methodology, but then there is the question of how we interpret what has happened from recent outturn data. If the figures are higher than we thought, do we expect that good news to persist and put it into the remainder of the forecast, or do we say, "This is noise" and assume that the figures will come back down to the level that we anticipated or maybe that there will be an undershoot next year to offset the overshoot this time? That is a key judgment about which reasonable—and unreasonable—people can always differ.

The Convener: Fascinating stuff. Are there any further points that you would like to raise with the committee before we wind up the session?

Robert Chote: No. You have covered the territory admirably.

The Convener: Thank you for your contributions and your responses to our questions again today, Robert.

I suspend the meeting. We will restart at 5 past 11.

10:55

Meeting suspended.

11:05

On resuming—

Draft Budget 2016-17

The Convener: Let us get the show back on the road. We will now take evidence on the draft budget 2016-17 from the Scottish Fiscal Commission. We are joined by Lady Susan Rice and Professor Campbell Leith. Professor Andrew Hughes Hallett had hoped to join us from the USA by videoconference but unfortunately that is not possible due to technical issues, and Jim Johnston was unable to lend us his private jet to get the professor over here in time for the committee meeting. I welcome our witnesses to the meeting and I invite Lady Rice to make an opening statement.

Lady Susan Rice CBE (Scottish Fiscal Commission): Thank you very much for having us back so soon after our last visit to the committee. On behalf of the commission, I offer you all good wishes for the new year. I also offer Andrew Hughes Hallett's apologies; he really wanted to be with us. I assure the committee that the three of us spent many hours on a phone call yesterday, so Campbell Leith and I are very current with Andrew's thinking. As with the run-up to the writing and finalisation of the report, if there are questions that we think are in his area of expertise, we will let you know that he might be able to add something further.

Since we last met on 25 November, the commission has published its "Report on Draft Budget 2016-17". We concluded that the forecasts were reasonable and made a number of recommendations. We note in particular that the forecasts are now being made on a five-year basis, which is good as it makes them consistent with other forecasts in the UK. In our eyes, it also perhaps adds some urgency to making some enhancements to the Scottish Government's forecasting methodologies that would make them more suitable for that five-year time frame.

You will have seen that our report has evolved: it is longer and fuller in explanation and background, and it contains appendices showing not just our activities over the year but the minutes of our challenge meetings with the Scottish Government. We started producing those minutes in August when we had the resources to do so. As minutes of meetings should be, they are agreed by all participants. As I said, the report has evolved—it even has a cover and paragraph numbers. I say that tongue in cheek, but we expect it to continue to evolve over time.

Our way of working has also evolved, and we hope that that is apparent to some extent in the report. We value our engagement with the Finance Committee and we have taken steps, such as producing the minutes, to provide evidence of transparency and independence—two themes that have come up in our discussions with the committee over the past year.

We note that the Finance Committee has published its report on the Scottish Fiscal Commission Bill; clearly, once the bill is finalised, it will lead to further evolution of the commission over time.

In our report, we have made some promises for the future. We have promised to develop a protocol in the coming year on how we work and how we interact with the Scottish Government. We have begun some early thinking on that. We state that we will do our own analysis of the outturn numbers once we have a full year's worth of outturn numbers for the devolved taxes. That is really important. We know that the Scottish Government will do that as well and clearly we will need to see where that takes us.

We also state that we will begin a programme of producing some technical papers and we are just starting to think about what they might comprise. We do not have any in the hopper at the moment so please do not look for them in a week or two, but they will come.

To conclude, I will state succinctly our key concerns in this year's assessment and scrutiny of the Scottish Government's forecasts.

On LBTT, we were pleased that, in looking at the tax for additional properties, the Scottish Government at least speculated and talked about behavioural factors. We think that those are important for all aspects of LBTT transactions, particularly given the five-year forecast time horizon. To our minds, it is increasingly urgent that the modelling for LBTT moves on and begins to incorporate appropriate behavioural factors.

There was discussion in the earlier evidence session about policy—today's policy and tomorrow's policy—and we are all keeping an eye on whether the Scottish Government's policy on landfill is having the effect that it is expected to have. The landfill tax is an area of real focus.

Non-domestic rates income is Andrew Hughes Hallett's key area of focus. As you will see in the report, we think that we have to bottom out the nature of the impact of buoyancy through the cycle—particularly what happens cyclically in terms of buoyancy. Once we have our arms around that, we can begin to pull in and look at wider and broader economic factors.

There is no real data on the additional properties tax. For that segment, we have very little to go on in Scotland, as we do not know a lot about who owns additional properties and how many they own. There is speculation about what the pool of properties might be, but some further work must be done in that area as well.

Finally, it is about outturns, which I just mentioned. We need to see what really happened in relation to previous forecasts.

Those are the areas of concern that we have expressed in the report. We have also expressed them verbally to the Scottish Government. We expect the Scottish Government to get back to us, as promised, with its views on our recommendations, outlining its plans and how it intends to react to those recommendations. We have stated in various fora, and I state again, that we believe that the Scottish Government will likely need to enhance its forecasting resources in order, for instance, to develop the LBTT model further. That is what we expect from the Scottish Government.

I invite the Finance Committee to give any feedback that it has on the report in addition to asking its questions.

The Convener: Thank you very much, Lady Rice. Professor Leith, is there anything that you wish to add at this point?

Professor Campbell Leith (Scottish Fiscal Commission): No, thank you.

The Convener: The report is excellent and comprehensive. It fulfils the transparency criteria because you have given great detail on all the meetings that you have had, with Scottish Government officials for example, and what was discussed at those meetings. Let us get into the report itself. I will open with some questions and my colleagues will come in subsequently.

I am intrigued by your statement in paragraph 1.21 that

> "in the analysis of residential LBTT, the Commission proposed that the forecasters might benefit from a review of the work of Best and Kleven (2015), which examined the impact of property taxes on the timing, volume and price of housing transactions. In each case, the forecasters choose themselves whether or not to pursue these alternative approaches."

You mention that again further on in the report. Would you like to tell us a wee bit about that? You have given us a wee bit of a teaser there.

Lady Rice: There are two aspects to that. The first is the importance of the Best and Kleven work, which Campbell Leith is best equipped to speak to. The other is highlighted in the last sentence in that paragraph. In our conversations and our challenge meetings with the Scottish Government, we might propose that the Government should look at a particular instrument in a certain way or bring in work that has been done externally, but it will not necessarily agree to do that. All that we do is challenge the Government to do those things; it then makes a choice about whether or not to do them, and it addresses some of those choices in the appendix to its forecasting methodology paper. That is why that last sentence appears there.

On the value of the Best and Kleven work, I hand over to Campbell Leith.

11:15

Professor Leith: The Best and Kleven paper is an academic paper that looks at the impact on the property market of changing property transaction taxes. It is one of a relatively small number of papers that look at that issue. When the Scottish Government was looking at the potential impacts of forestalling, we recommended that it look at that paper in depth and, using Scottish data, maybe try to replicate what the paper had done in order to assess the magnitude of forestalling and behavioural effects. We dipped into the academic literature, provided the Scottish Government with that resource and suggested that it might be worth looking at it to enhance its forecasting efforts.

The Convener: Okay. Thank you for that.

Paragraph 3.5 of the report states:

> "What drove the Commission's initial concerns is that the current forecasting methods essentially amount to an extrapolation of historical data for house prices and transactions towards a long-run average."

Paragraph 3.6 states:

> "some kind of ongoing assessment of the sustainability of developments in the housing market would be a useful way of monitoring possible corrections to the market and the impact that would have on forecast revenues."

Paragraph 3.7 states what Lady Rice emphasised in her opening statement, which is that

> "the current approach contains no behavioural responses to changes in tax regime."

That point is repeated in the report. Can you explain those comments in the report a bit more?

Professor Leith: The current approach to forecasting residential LBTT revenues is essentially built up from a forecast for house prices and a forecast for transactions, which are then applied to a probability distribution that gives the probability that we will observe a transaction at a particular house value. The driving factors are prices and aggregate transactions. Prices are forecast using what is called an autoregressive integrated moving average—ARIMA—model, which is essentially a statistical approach that says that house prices next year will be a function of house prices in the past. It is a kind of statistical extrapolation of historical house-price growth. The transactions data is not modelled in a statistical way but is an extrapolation from more recent data towards the kind of long-term average that Robert Chote talked about earlier.

Both those approaches—the estimates of the ARIMA model and the fundamental approach of extrapolating transactions—essentially take historical data and move house-price growth and transactions towards their long-run averages. However, that would not capture the economy going into a boom, with house prices or transactions moving away from the long-term average; nor would it capture a boom or a bust in the housing market. The statistical evidence from the literature suggests also that it would not capture the transition from a boom to a bust—it would not capture the turning point where a housing market bubble was going to burst.

The literature suggests that we need a more multivariate approach that uses a range of variables, possibly with more theoretical grounding inherent in the modelling. That is incredibly difficult to do, but there are approaches out there that work in some instances, and we would encourage the Scottish Government to pursue those. They may work, but they may not.

The Convener: Okay. Thank you for that.

In terms of non-domestic rates income, paragraph 5.4 of the SFC report states:

> "In the forecasting of buoyancy for the 2015-16 Draft Budget, Scottish Government forecasters used a range of macroeconomic data to justify raising the buoyancy forecast above its historical average. The Commission discouraged this approach as no link between the macroeconomic variables and buoyancy had been formally demonstrated to justify the magnitude of the adjustment."

The following paragraphs say more about buoyancy. Can you give us a bit more of your thinking on buoyancy and how the Scottish Government can improve, shall we say, its forecasting in that area?

Professor Leith: Okay. Last year, the Scottish Government approached the issue of forecasting buoyancy by starting from the long-run average, then it looked at a range of economic indicators to see whether, for example, GDP growth was higher, unemployment was going down or business confidence was going up. If the Scottish Government believed that the economy was strengthening, it would shift the buoyancy forecast above its average; if it believed that the economy was not strengthening, it would shift the average down.

The problem that we had with that was that there was no formal assessment. I suppose that GDP growth has increased by 0.5 per cent but how does that 0.5 per cent translate into the deviation of buoyancy from its long-run average? Should buoyancy go up by 0.5 per cent as well? Should it go up by 1 per cent or less than that? There was no formal link between the two. Our position was that until that formal link was demonstrated, the adjustment was essentially ad hoc.

There was a limited span of data for buoyancy subsequently, so it was difficult to do any modelling work on buoyancy at all. We recommended that the Government try to obtain a longer historical series for buoyancy. It managed to obtain such a series and create a second proxy series from NDRI receipts, so we now have two historical data series for buoyancy.

If you look at those two series, you will see that there seems to be a cyclical pattern. Every time there is a revaluation cycle, there is a peak in buoyancy that slowly declines; then there is another revaluation year, buoyancy jumps back up again and then slowly declines. Given the way in which the buoyancy numbers are constructed, revaluation cycles should have no impact on buoyancy, so why that was the pattern is a bit of a puzzle.

Throughout the year, we have pushed the Scottish Government on the matter and explored with the Scottish Assessors Association why the pattern exists, given that, a priori, we are not quite sure why it should exist. They have come up with the story about the relationship between the revaluation cycle and what are called rolling revaluations. The idea is that the rateable value of a property can be appealed at any point in time if the nature of the property changes, but revaluations can be appealed only in the year in which they occur.

What tends to happen is that the rolling revaluations are resolved only when the revaluation appeals are resolved. That gives a mechanism for explaining the cyclical pattern. We have encouraged the Scottish Government to quantify whether it can reasonably explain the pattern, and we now believe that it can. We are looking for further work on that to strengthen our description of the cyclical pattern because only by controlling that can we extract the residual information from the series to assess to what extent buoyancy is affected by other economic variables such as GDP growth, unemployment and all the rest.

We are half way through a process of enhancing the description of the data to allow a more formal modelling of buoyancy in the future.

The Convener: Thank you for that comprehensive answer.

I move on to the additional land and buildings transaction tax, which is new for 2016-17. Paragraph 7.1 of your report says that

"The proposed 3% slab tax is envisaged to be applied to additional residential property transactions in excess of £40,000"

and that there is an estimate of

"the revenues generated of between £45m-£75m".

However, you also say that

"the transaction tax will effectively wipe out the return in the first year of a buy-to-let investment",

for the reasons that you explain. You say that

"This will affect the price distribution for the first homes. At present, this is not in the forecasting model."

In paragraph 7.9, you ultimately suggest a final revenue estimate for 2016-17 of between £17 million and £29 million. That is significantly different from what the Scottish Government predicts. Will you talk us through your thinking on that significant difference?

Professor Leith: The figures are from the Scottish Government; we are talking through the various adjustments that the Government has made to the underlying forecast. There is the base forecast, which tries to identify the transactions that would fall under the tax if everything proceeded as it currently does. There are bits of information about the extent of buy-to-let mortgages, the number of purchases of such properties through the year and so on. They give rise to the first headline figure.

The Scottish Government has made various adjustments in an effort to reflect behavioural factors. This is one case in which it is trying to take account of behavioural impacts. A series of adjustments are made and the forecast is ultimately downgraded once those behavioural responses are taken account of. That is essentially what the note details.

The Convener: That is fine.

In the section of your report entitled "Improving the Forecasting Process", you say in paragraph 8.2:

"data limitations may place a constraint on the forecasters' ability to apply more sophisticated methods."

You go on to say:

"we are increasingly concerned about the residential LBTT forecasts which still assume no behavioural responses."

There are two issues. The first is whether the availability of data has been improving. That issue has concerned the committee for a number of years. You mentioned the limited span of data on buoyancy for non-domestic rates income. Given that you think that there are issues with the availability of data, what areas should the Scottish Government focus on in improving data availability, where that is possible?

Professor Leith: A number of improvements have been made in data availability through the years. For the buoyancy figures, we now have a longer historical time series, albeit that it is not tremendously long, and there are two versions of that time series. That is a clear improvement.

In addition, we are starting to get outcome data from the taxes, which helps us to assess the validity of the forecasts. There is also a new series from Her Majesty's Revenue and Customs on property transactions in the non-residential sector in Scotland, which was not previously available. That has allowed us to undertake further evaluation of the validity of the underlying forecast. Therefore, data is coming on stream.

In some of our recommendations, we encourage the Scottish Government to look at more micro data on transactions, which should exist. We would like it to look at individual transactions so that it can get the distribution of transactions across the price range of properties. We believe that there are cases in which data exists, and we ask the Scottish Government forecasters to use that data. However, as always, there is never enough data. With any piece of data, the longer the run we can get, the better.

The Convener: You would also like more emphasis on behavioural responses.

Professor Leith: Yes.

Lady Rice: I will add a footnote to what Campbell Leith said. There might be instances in which it is not possible to get data. For example, at the high end of property transactions in Scotland, the numbers are low enough that it might be possible, were HMRC to release the data, to identify taxpayers, properties and so forth. In looking at micro data, we might reach a point at which there are restrictions and limitations.

The Convener: I will now open out the session. The first colleague to ask questions will be John Mason.

John Mason (Glasgow Shettleston) (SNP): Thank you for your report, which makes good reading. I picked out a few things on my way through it. Lady Rice mentioned having a protocol. That is referred to in paragraph 1.24 on page 5 of the report, which says that the SFC's scrutiny of the Scottish Government's forecasts of receipts will be developed into a protocol. Will you explain what that means?

Lady Rice: I am searching for the right word, which might not be a technical word. The purpose of the protocol is to respond to some conversations that we have had with the committee. You wanted people to feel that they understand how we operate. The protocol will build on the most recent year's experience, which was much fuller and richer for us. It will describe how we interact with the Scottish Government, what we do, what our programme of work is during the year and how we go about doing those things. The idea of the protocol has been developed in response to some of what the committee helped us to focus on in past conversations.

John Mason: That is helpful. There will probably be an agreement between the commission and the Government, but the protocol will give the commission's angle on how it views its role.

Lady Rice: The protocol will set out how we intend to do our work.

Professor Leith: The way in which we develop the protocol will be contingent on the remit that we ultimately get from the Scottish Fiscal Commission Bill and the response to the committee's report as the bill goes through Parliament.

11:30

John Mason: I will come back to that later, but first I will turn to other specifics. Paragraph 3.5 on page 8 of the SFC's report highlights concerns

"that the current forecasting methods"

are an

"extrapolation of historical data".

It makes a point about whether,

"if the housing market was drifting away from its long-term average",

that would be picked up in the forecasting.

I was interested to read that, and Mr Chote mentioned it in his evidence; I think that you were in the room at that point. There is a whole issue about whether we are on a long-term trend or returning to a long-term trend, whether a new trend is starting and how we know the difference. Will you explain your concerns?

Professor Leith: The nuts and bolts of forecasting are about discerning what is going on and discerning whether something is a long-term trend or whether there are just cyclical components and random variations. One can use a host of techniques to identify what is going on with regard to specific variables. The approach that the Scottish Government is adopting to the housing market involves a straightforward extrapolation technique, which works well in normal times but would not capture instances in which a new trend was developing and we were moving away from what we had previously.

John Mason: If a new trend is starting, surely it is impossible to predict.

Professor Leith: There are techniques for identifying time variation in trends, so people can see that a historical trend no longer applies to the current data releases.

John Mason: So it is a question of picking up a new trend once it has started.

Professor Leith: It depends. In simple statistical models, techniques can be used that allow people to pick up new trends as they develop. The idea is that turning points are picked up quickly.

There is also more structural modelling, which says that, fundamentally, house prices should be driven by the earnings of the people who are buying the houses, the state of the economy and so on. That is a far bigger economic modelling exercise but, with such modelling, you might even be able to anticipate the turning point, which is the holy grail of forecasting. There are examples in the literature in which people claim that certain techniques can do that at certain points in time.

John Mason: I remain slightly sceptical about whether you will ever get the holy grail.

The convener touched on an issue that is linked to that. Paragraph 3.23 on page 14 states that it

"remains unclear ... to what extent this is a temporary phenomenon"

and whether

"certain sections of the market will reduce activity in the longer-term."

Again, there is the question of what is temporary and what is more permanent.

It has been mentioned that the private letting sector, or buy to let, is expanding. Is that the kind of longer-term change from which there might be an impact?

Professor Leith: There are various factors—table 1 on page 10 of the report might help to frame the answer to that question. Table 1 contains evidence that we gave to the committee previously; it is based on the attempt to assess how well the outturn data mapped to the forecast. In the first couple of columns, the table allocates the forecast of £235 million for residential LBTT across months, given the seasonal variability that occurs in house prices and transactions. We then contrast that with the outturn data to get the size of the forecast error.

That is—or could be interpreted as—a measure of the forestalling that has gone on in that market. We were interested in seeing the extent to which the forecast error has tapered away as we have moved away from the date on which the tax was implemented. We have gathered an extra month of data since we constructed the table, which for the first time contains a negative forecast error, as more revenue was generated than was forecast.

John Mason: We have the 3 per cent from the next tax change coming in, so I presume that forestalling for that is starting already.

Professor Leith: Yes—it should be starting now, so it is not in the November numbers.

John Mason: So the two areas of forestalling will interact with each other.

Professor Leith: There is forestalling on top of forestalling. Yes. The interesting thing from the updated data in table 1 is that what we were concerned with before was that it looked as though forestalling was tapering away by August, but it seemed to bounce back again in September. The information for the two subsequent months of October and November that we now have seems to suggest that the forecast is back on track at that point. As an initial look, it looks as though the forestalling has bottomed out at around £30 million.

John Mason: That is helpful. Thank you.

On headline forecasts, paragraph 3.31 on page 16 of the Scottish Fiscal Commission's report talks about the

"unfortunate inconsistency in the way the Scottish Government and OBR report their residential LBTT forecast in the presence of forestalling effects"

and whether they are included in the headline forecasts. Is that important or just a presentational thing?

Professor Leith: No. It is a very minor aside.

John Mason: We will leave that then.

I think that the convener said that he understood the whole report, which is good, but I struggled with some words in it. Could you explain what paragraph 3.32 says? It talks about the

"simple univariate forecasting of house prices".

I was not quite sure that I knew what "univariate" means.

Professor Leith: There is univariate versus multivariate. Univariate forecasting involves taking the historical data for house prices and extrapolating forward to predict house prices; house prices are therefore the only variable that is used to forecast house prices. A multivariate approach would use house prices, interest rates, mortgage availability and all kinds of data to forecast house prices. One variable forecasts one variable in a univariate approach.

John Mason: Is it fair to say that univariate forecasting is simplistic, or is that unfair?

Professor Leith: It is simpler.

The Convener: That is an indictment of the education system.

John Mason: I am not sure that I understood another thing. Paragraph 3.39 on page 18 says:

"We regressed the natural logarithm".

I vaguely remember logarithms at school, but I was toiling a little bit. Will you explain what you tried to do there? Are we saying that the question is whether, as the UK market changes, the Scottish market is changing in exactly the same way or in a slightly different way?

Professor Leith: Yes. The Scottish Government used for its forecast the OBR's forecasts for transactions in the non-residential market. I think that HMRC published data on the Scottish equivalent data in October. Therefore, we now have data for non-commercial property transactions for Scotland. Given that we now have those two data series, we can now look to see to what extent they move together and whether it is a good assumption to use the OBR forecasts in the Scottish forecasts for non-residential LBTT. We take the two data series for the UK data and the Scottish data and say, "Suppose the UK transactions go up by 1 per cent. What percentage increase in transactions in Scotland should we expect?" We should roughly expect a 1 per cent increase in Scotland, too. Therefore, using the UK data for Scotland in that instance does not seem like a bad thing to do.

John Mason: That paragraph ends up saying:

"UK transactions can explain 89% or 87% of the variation in Scottish transactions".

The next paragraph says that

"neither estimate is statistically significantly different from unity",

so 87 and 89 per cent are not significant.

Professor Leith: The difference from unity is the elasticity. We measure how much Scottish transactions change when UK transactions change by 1 per cent. The estimate is 0.94 in one case and 1.08 in the other, which are not statistically significantly different from one. Basically, when UK transactions go up by 1 per cent, Scottish transactions would be expected to go up by 1 per cent, as well.

John Mason: That is helpful. Thank you.

Paragraph 7.10 on page 36 also mentions elasticity. You emphasise there that there is a huge amount of uncertainty around a 3 per cent LBTT, I think, as the closest example that we have is

"the Stamp Duty holiday of 2008".

You seem to me to really emphasise the uncertainty. You then say:

"bearing these caveats in mind, we are prepared to endorse these forecasts as reasonable".

That seems a little strange to me. You say that it is very uncertain. Are you just saying that it is impossible to know so anything is reasonable?

Professor Leith: Yes. It is a bit like the Bank of England's inflation forecast—I think that we have discussed it in the past—which has fan charts that have the bank's central estimates and then the range of uncertainty, which widens as we push it forward in time. In essence, we are saying that the central estimate is reasonable but the uncertainty round about it is very large.

John Mason: In paragraph 8.2 on page 37, you talk about the forecasting methodologies and the challenge meetings that you have had. I am impressed with the report. Some of the terminology is at the edges of my understanding, but I am glad that somebody other than the Finance Committee is challenging the forecasts, because the committee could not have done such work. That makes me ask whether, if you as the commission produced the forecasts, there is somebody who could have such challenge meetings with you. How would we handle that challenge function?

Lady Rice: That is an absolutely pertinent question, particularly if that were to come out of the Scottish Fiscal Commission Bill in due course. As we have said before, we have a system in which the Government produces the official forecasts and the commission assesses them. If we were to produce the official forecasts—the forecasts with a capital F, as I said at our previous meeting—we would absolutely want them to be challenged and scrutinised by another body, as would you. For us to do that, Parliament might have to think about what that other body would be and whether a new body would need to be created to do it. It would cause great concern if the commission simply produced the official forecasts and that was it.

John Mason: That is my point.

Mark McDonald: The deputy convener's questioning was quite comprehensive, but I have a couple of additional questions. My first one touches on Professor Leith's remarks about the holy grail of forecasting: the ability to predict boom and bust. If it were possible, would somebody not be doing it? How much would it become a self-fulfilling prophecy, particularly if you predict that a bubble will burst? If you say that, in year X, we think that the housing market bubble will burst, will it become a self-fulfilling prophecy because the markets react according to your prediction?

Professor Leith: There is quite a large literature on all aspects of forecasting and that is just one of them. There are examples in that literature of people constructing models that, out of sample, are able to forecast key events. However, there is also a lot of evidence of models that looked good in the past but which, when a big change happened, missed it completely.

Forecasting is an imperfect science and there are many approaches. It is best to employ a range of approaches so that, if one of them rings alarm bells about a possible bubble in the housing market, we can look into it more deeply. If the other approaches are not ringing alarm bells, we try to reconcile them. The Bank of England employs a suite of models to forecast the economy, not just one, so I recommend that we use all the analytical tools that we have available to come at it from every angle.

Mark McDonald: How much does that add to the time that is required to undertake the forecasting and the challenge element of it? Would an additional cost in terms of human resource be required to undertake the more complicated forecasting that you described?

Professor Leith: The last time we met, we discussed that in some detail. You would probably undertake the simpler forecasting methods on a day-to-day, year-to-year basis as the fundamental driver of the forecast and do deeper, more sophisticated, one-off pieces of analysis that help to identify the turning points or whether there are significant behavioural factors that you need to take account or do not need to take account of.

It is a kind of complementary approach whereby more fundamental, deeper economic analysis is undertaken to assess whether there are issues that really need to be taken account of in applying simpler, day-to-day forecasting techniques. That analysis may mean that you do not need to worry about the issue or it may flag it up as being important.

11:45

Mark McDonald: Let us set aside the convener's caveat regarding the commission's role and what its remit will be once the bill has been passed. On the basis of what is proposed in the bill, is that a function that the commission would carry out in its challenge role, or would the commission expect the Government itself to carry that out following challenge or to be challenged and probed by the commission thereafter? How do you see that function evolving?

Professor Leith: At the moment, we have the possibility of producing our own technical working papers, and we have a number of projects under way that are looking at various issues—those would be our own pieces of research. Depending on what those pieces of research delivered, we would take them to the Scottish Government and say that the research had highlighted important issues that the Scottish Government's forecasts, which it owned, should ideally take account of. It would then be up to the Scottish Government to decide whether to incorporate those extra pieces of analysis that we had produced independently.

Mark McDonald: Let us move on to the devolved taxes, specifically LBTT. We had a discussion about forestalling in which the deputy convener helpfully highlighted the slab tax that will, in the coming financial year, apply to second properties, which are generally but not always buy-to-let properties, and the potential for a forestalling effect in those properties beginning to emerge. I have two questions. First, you have mentioned that a longer-term analysis of LBTT transactions would be required to understand how much the figures were affected by forestalling and how much they were affected by deeper market changes or other external factors. How long a period would be required for that? Secondly, at what point would you be able to make a reasonable assumption of a forestalling impact in relation to the slab tax that is being introduced in the current financial year? At what point would we be able to look at the figures and say that the differences were the result of that and not something else?

Professor Leith: Table 1, to which I referred earlier, is a first-pass attempt to see whether forestalling has come to an end. By looking through the forecast errors, we see that there were large differences immediately after the introduction of the tax, although they have now tapered away. As a first pass, that gives us some confidence that, by November, the forestalling effects will have come to a close. However, we will want to look at that more deeply. We will try to look at the micro-data and the distribution of individual transactions to assess whether, maybe at the top of the market, there is still an on-going forestalling effect that is being compensated for by some other part of the distribution that is driving the figures.

We have some initial evidence and we will look at the issue more deeply. It could be that, by this point, we should be able to pull together the necessary data to reach that conclusion.

Mark McDonald: Does the fact that there are no Scottish stamp duty figures for any period prior to the current financial year hamper some of that effort?

Professor Leith: It hampers our ability to look at the mirror image of the forestalling, which is the transactions that were brought forward. We present some evidence—it is anecdotal, to some extent—of what happened before, which is based on the evidence that we provided to the committee at the previous meeting that we attended, but it is not comparable in quality with the data that we have post the introduction of the tax.

Mark McDonald: My second question was about the impact of forestalling until the following financial year relating to properties that will be subject to the slab tax after the commencement of the next financial year. They will not be easily identifiable because they will not be paying that tax, so you will not be able to disaggregate them on that basis. If we see a spike in one or more months, how easy will it be to point at it and say that it is a result of forestalling rather than some other market impact?

Professor Leith: It would be extremely difficult to disentangle. We will probably have to wait until the tax has been introduced and then see how the revenue figures for it evolve over time.

Lady Rice: We will probably need to look at more than one fiscal year and see what patterns arise. Embedded in forestalling is a conundrum, because we will never really know who has changed their mind and not gone in for a transaction because of the change in tax.

Mark McDonald: I guess that the question is about the variability. You said that we will need to look at more than one fiscal year, and I think that that is what I was driving at. At what point will we legitimately be able to say that we have enough data to be able to assess the impact of the LBTT rates, taking into account forestalling effects et cetera versus any other impacts that might be in play?

Professor Leith: We can take the forecast of what the new measure will deliver pre and post-forestalling and see whether the outturn data matches the post-forestalling figures. Essentially, however, our assessment will be contingent on both the underlying forecast and the estimate of the forestalling being right, so it is difficult to disentangle.

Mark McDonald: Thank you.

Gavin Brown: Good morning. Right at the end of the formal part of the report, you conclude:

> "On the whole, the Commission found these forecasts, within the constraints of the available data, to be reasonable."

Just for clarity, are you saying that the forecasts are reasonable for the financial year 2016-17 or that they are reasonable for the whole of the forecast period?

Professor Leith: We are saying that they are reasonable for the whole of the forecast period, but we emphasise that the error bands around them widen as we move forward in time.

Gavin Brown: But they are reasonable for the whole period and not just for 2016-17.

Professor Leith: Yes.

Lady Rice: Yes. The forecast embodies the five years.

Gavin Brown: Thank you. I just wanted to be clear about that.

Moving on to LBTT, I do not have any questions about the non-residential model. I concur with the convener; I quite like what you have done with the reverse logarithm and so on, which leads me to have no questions on that area. I have questions on the residential model, though, as you might expect.

The Scottish Government forecast for the next financial year for residential ignores the transaction supplement—it ignores the additional tax. Outside of that, its forecast for residential transactions for the next financial year is £295 million, which you think is reasonable. I would like to get a sense of what you believe would be unreasonable, at both the upper and lower ends. You might not have exact numbers, but where would we begin to get into unreasonable territory?

Professor Leith: Shall I go first?

Lady Rice: Yes. It might be that we are going to say the same thing.

Professor Leith: A large part of what I would define as reasonable is contingent on the method that is used to generate the forecast. I have gone into the spreadsheet that details all the underpinning assumptions and the technical modelling aspects that underpin the forecast. When I go through those assumptions and look at the way the modelling works, I am looking for things where I say, “That is obviously inconsistent with the data,” “That’s a bad assumption to make,” or, “I don’t believe that assumption”—things that lead me to believe that the forecast is not reasonable.

Scrutiny meetings are about going through the method in lots of detail and giving tough challenges—“Why are you doing it this way? Does the data not suggest that you should be doing it that way? Justify why it is done this way. Give us the evidence that explains why it is done this way.” That is what underpins our decisions about reasonableness.

Lady Rice: It is an important question because people should not assume that we are looking at the output numbers and saying, “That is the right number and that is the wrong number; that is better and that is worse.” We are not looking at the outputs; we are looking at the inputs. It is an important distinction to make.

We are making our judgments on the inputs. We are asking, “What is the basis for those numbers? What are the factors, and therefore what are the numbers and the time series—whatever they are—that are going into each of those forecasting models?” However, we are not then saying, “We think that that number is the right number.” We are not making that judgment.

Gavin Brown: You are not coming down on a right number, but I want to go back to the comparison with the Bank of England fan charts that Professor Leith mentioned earlier. I am pleased to hear that you are playing about with the model and you are looking at all the assumptions—that is what I would hope for and expect. However, in doing all that, can you not then get a sense of what an unreasonable number would be, at a higher or a lower end, or is that simply impossible?

Lady Rice: It is about the methodologies. If the forecasters failed to include some important factors when they ran their model, we would likely say that the model was unreasonable because they were not giving us enough evidence to say that it was legitimate. The number is just the output of the sausage machine, if you will; we are looking at what goes in.

Professor Leith: Maybe I can give another example that goes back to last year’s report. As I think we have already discussed, when buoyancy was being forecast last year, the long-run average was taken and then an adjustment was made that depended on the forecasters’ view of the general state of the economy, but the measure of the state of the economy was not formally linked to the adjustment to buoyancy.

The adjustment that was made pushed the increase in buoyancy to the level at which it would have been one of the largest increases in buoyancy we would have seen in the limited span of data that we had. I think that we described that as being very optimistic; it was on the cusp of becoming unreasonable. If it had been pushed any further, we would have reached a limit, at which point we would have said, “No, that is just unacceptable.”

Gavin Brown: I have read through all the comments that you made about residential LBTT revenue. You set out a number of areas for development and a number of concerns; let us take them all together.

First, you think that there should be a multivariate approach. Next, you think that there should be an examination of the distributional changes. You then say that you are “increasingly concerned” that there is no behavioural analysis whatsoever in relation to the primary part of LBTT. You also raise some questions about £188 million out of the £545 million forecast revenue coming purely from fiscal drag.

There are four concerns there and two of them seem quite major. How can you then sign off the residential LBTT forecast as reasonable despite all those concerns and given that you have used the term “increasingly concerned”?

Professor Leith: Our concern is that, in terms of economic theory, we would expect there to be a behavioural response to relatively high tax rates and, given the fiscal drag effects that we document, more and more transactions are being pushed into that part of the distribution.

The issue is that we do not quite know how big those effects are. Are they significant? Are they small? Are they something that we really need to worry about, or are we worrying about nothing? Currently, there is not enough evidence to tip us into saying that the forecasts are unreasonable. We do however wish to look at this area and gather the evidence so that we can then say either, “Those forecasts really need to take account of that factor” or, “It is not as big a deal as we thought.”

Gavin Brown: I asked whether those concerns were pushing you towards saying that the forecast was unreasonable because of what I read in the Scottish Government’s devolved taxes forecasting methodology paper. When it looks at the supplementary charge on LBTT—the bit that was announced at the budget—it covers behavioural impact. It accepts entirely that there will be a behavioural impact.

The Scottish Government projection is that it will collect £23 million next year from the supplementary part of the tax. It reckons that behavioural impact has affected that £23 million by between £8 million and £13 million, which is quite a huge slice. If that £23 million has been affected by that much, what sort of effect could there be on £295 million? If the change is of a similar magnitude—that is a big “if”—but you are assuming no behavioural impact, those forecasts would be unreasonable.

What needs to happen on behavioural impact? From what I can see, you mentioned it to the Government at every meeting you had with it last year. You are now using phrases such as “increasingly concerned”, but it is still assuming that there will be no behavioural impact. At what point does that become unreasonable?

12:00

Professor Leith: On the additional measure, one would probably expect behavioural effects to be far stronger in a very specific segment of the market than one would in the market as a whole. They are slightly separate bits of the market.

We hope that the Scottish Government will tell us how it plans to respond to our recommendations.

Gavin Brown: I will move on to non-domestic rates. I appreciate that that is Professor Hughes Hallett’s specialism, so he may wish add his comments in future.

From what I can see we are only getting a one-year forecast for non-domestic rates. Is that correct, or have I missed something?

Professor Leith: We evaluated a five-year buoyancy forecast that takes account of the cyclical pattern that I discussed earlier. We looked at the full five-year—

Gavin Brown: That is the buoyancy, but this is a question of clarity about the actual numbers. I can only see one year’s worth of numbers in the budget. Have you seen five years’ worth of numbers?

Professor Leith: Our remit tells to focus on buoyancy, so that is what we have been evaluating. I am not sure whether or not we saw the revenue implications of those forecasts; I cannot remember, to be honest.

Gavin Brown: I appreciate that your remit is different. I was just wondering whether I had missed the figures somewhere. Maybe I did not, if that is the case.

Your remit is to look at buoyancy, so it is harder for you to comment on the numbers, but let us look at patterns. In the budget, the forecast for non-domestic rates is about £30 million lower for the next financial year—2016-17—than it was for 2015-16. You do not look at the exact numbers, but given that the economy is growing, and that there are projected increases for the other taxes that you looked at, does it not strike you as unusual that non-domestic rates income in cash terms is projected to be lower in the next financial year? Did you discuss that with the Government?

Professor Leith: The reason for that is the very cyclical pattern that I discussed earlier. In previous years, no adjustment was made for the cyclical pattern, because the data span was not long enough for us to identify it. Now that we have found it to exist, the Scottish Government has adjusted its buoyancy forecast—and therefore the non-domestic rates income forecast—to account for it. Given where we are in the revaluation cycle, one would expect the revenues to reduce.

Gavin Brown: That might have reduced the figure against the initial forecast. Are you saying that that buoyancy change could, in effect, be bigger than economic growth, and therefore we would collect less in cash terms?

Professor Leith: The buoyancy forecast does not take account of economic growth, which is another issue that we have discussed. Previously, we were adjusting it in an ad hoc fashion, based on broad-brush evidence on the state of the economy. In our report we are asking Scottish Government forecasters, once we have controlled for the cyclical pattern, to squeeze whatever information is in that data series and relate it to the economic determinants for buoyancy, to take account of those factors.

Gavin Brown: When the cabinet secretary gave his statement to Parliament on the budget, he said that he was increasing the large business supplement of non-domestic rates and said that he thought that that would bring in an additional £130 million—I think that I wrote it down correctly when he said it. Were you asked to think about that, or was it outwith your remit?

Professor Leith: It was outwith our remit.

Gavin Brown: Okay, thank you.

Jean Urquhart (Highlands and Islands) (Ind): In paragraph 1.21 on page 4, you discuss the challenging meetings that you have. Am I right in assuming that it is you who has those meetings?

Professor Leith: Yes.

Jean Urquhart: Going back to the relationship that you have with the Scottish Government, and your independence, will that change over time, in relation to staff and so on?

Professor Leith: At the moment, the Scottish Fiscal Commission is present along with two part-time research assistants, who attend the meetings largely in an observational capacity.

Lady Rice: They also take away some work assignments.

Professor Leith: The information that they gather about the discussions can inform the work that they do.

Jean Urquhart: In the two meetings that we have had with the cabinet secretary during which this matter has been dealt with, he has been adamant that he will accept whatever changes the SFC proposes to the budget or the outcomes that are being forecast. Is it your understanding that, provided that your suggestions are reasonable, they will be accepted and presented by the Scottish Government?

Lady Rice: From our reading of the *Official Reports* of those meetings, we understand that the cabinet secretary will want to go to Parliament with a draft budget only when the budget is seen to be reasonable. My interpretation of that is that he would not bring to Parliament a budget that is not seen to be sensible, because that would not make any sense. That is how I understand his thinking; I may or may not be correct.

We are not advising or guiding; we are not doing the other kind of work. All we can do is ask for evidence for why certain numbers have been included and why a particular instrument has been approached in a certain way and not in another, or ask whether the Government can consider a certain thing and come back and tell us whether it has made any difference.

At some point, we will decide that the Government has provided adequate evidence and has followed its model and so on, which will allow us to make a judgment about reasonableness. For example, a forecast might be judged to be reasonable one year and be kept for the next year, but a major policy change might knock it out of that reasonable space. We would have to speak about that and challenge the Government. That is what we do. We do not say, at the end of the day, "These are the right numbers." There is a difference between the input numbers and the output numbers.

Professor Leith: I should perhaps also emphasise that in the series of challenge or scrutiny meetings with the Scottish Government forecasters, at no point do we say, "That's it. You've done enough to get a gold star and now everything will be judged as being reasonable." We are critical all the way through and we write our report after the final forecasts come out.

Lady Rice: As I think that I said earlier, we do not come to a point of agreement with the forecasters: we do not say, "Fine—we'll sign off on this." We continue simply to challenge and, at the end of the day, they create the forecast.

Jean Urquhart: You mentioned that you do not come to the challenge meetings with new ideas; you simply react to information that you are given. However, earlier, Professor Leith told Mark McDonald that there are a number of issues that you have been working on and do not know whether the Government would accept them. My next question relates to that point. The biggest change that is coming down the line is the outcome of the Smith commission, and eventually we will have a referendum on Europe. How are those issues dealt with in your thinking in relation to Government thinking?

Lady Rice: There are two parts to that question. First, I do not recollect saying that we bring nothing new to the table. The Best and Kleven paper, which we have discussed as an example, was something new that we brought in, and a lot of the challenge is new to the conversation, so I am not sure what I meant, at that point. Of course we bring in new things. That is the nature of challenge: we are looking for areas that may not have been addressed or thought about. Sometimes the challenge is to ask people to explain to us what their thinking is and what goes into it. That is one aspect.

On the second part of your question—I will give Campbell Leith more time to think about his response—we have been quite careful to look closely at what might happen in the future, but we have the present to consider and we have a remit right now, the exigencies of which we need to meet now. We cannot start developing a report that speculates about what legislation will mean or what the outcome of the Smith proposals will give to us. We know that there will be changes, and we are starting to plan for those and think about them, but that is separate from the job that we have to do today. We felt that it was important to focus on what Parliament expects from us and to do that as well as we can, and not to conflate two different aspects.

Your implication is correct that there is a lot of change to come and that we need to be on top of that.

Jean Urquhart: Is that something that you can do independently, or would you be asked to do it? I suspect that a lot of people will want to know what the financial and economic implications will be for Scotland of being in or out of Europe, given the arguments that have been made. Would the Scottish Government charge you with looking at that?

Lady Rice: I doubt it, but—

Professor Leith: Assessing the costs and benefits of leaving Europe would be outside our current remit. Speaking personally, given the position that I now have in the Scottish Fiscal Commission, I have my own wide research agenda in which I am undertaking a number of projects that directly relate to what we anticipate is coming down the line. With colleagues at the University of Durham and a PhD student in Glasgow, we are starting work on building a macroeconometric model for Scotland. We are looking at dynamic Laffer curves and how variations in tax rates affect revenues, and are considering those calculations with regard to Scotland. With another colleague and another PhD student, we are carrying out a big data analysis of newspaper articles in order to build uncertainty indices for Scotland vis-à-vis the rest of the UK, and things such as that. There is a whole bunch of projects under way that will, I hope, be of use to our future scrutiny work.

Lady Rice: There may be other projects, as well, because the academic community is probably only the first place that one might look for some of those answers.

Jackie Baillie: I want to start where Gavin Brown left off, because I am curious about your response regarding when “reasonable” becomes “unreasonable”. I absolutely accept the distinction between the figures and the method by which this is all assessed.

I enjoyed reading your reports from both last year and this year. You are consistent in asking for data on behavioural responses for residential LBTT. In fact, your recommendation in this year’s report is framed in slightly stronger language. I do not know whether that implies frustration that you have not received the data yet, but I am curious to know when you will consider that you have given the Scottish Government enough time to respond to that recommendation.

As you describe, we can all recognise the issue of behavioural responses arising from LBTT and the issue of forestalling, which the OBR assessed. We are now going to get an additional behavioural response from the additional LBTT. It seems as if we have just stuck our finger in the wind to assess that. I am curious to know when you will become increasingly impatient.

Lady Rice: I think—and I think that the forecasters would concur—that we have been more impatient this year than we were in the previous year. In the forecasting methodology paper, which the Government submitted to the committee, annexe 1 talks about the recommendations that we made for the 2015-16 draft budget and the Government’s response to them. The Government knows, and we know, that there has not been much response, and we have had discussions about that. The Government knows that we see the behavioural factors in particular as important—especially now that we have a five-year forecast horizon. That is what creates the urgency. The issue is not that we are getting impatient with others on a personal level; it is that the forecasts are now not for two years but for five and so we need better texture in what comes out. We hope to see changes in the next round.

12:15

Jackie Baillie: Professor Leith used the same language, in that he talked about hope. Do you have more than hope? You are right that that document does not tell us much about what the Government is doing on the issue. In fact, there is no mention of behaviour in the list of actions that are being taken on residential LBTT. I am curious as to when you will get beyond hope.

Professor Leith: It is up to the Scottish Government to respond. To add to what Susan Rice said, as our remit becomes clearer and as our resources come on stream, we will start to do the analysis ourselves. If we think that the issue is important, we will look at it.

Lady Rice: If, in our judgment, the issue turns out to be important, that will be a major challenge, and it will become more urgent, because we will have the evidence.

Jackie Baillie: That is helpful to know.

It is extremely helpful to have the minutes of your meetings with the forecasters, as they describe some of the discussions. However, I am less than clear about one issue. In August, you asked for something quite specific on LBTT in relation to seasonality, and in September you repeated the request. There is nothing in the November minute that indicates that you got that, although I assume that you did. For the sake of clarity, and for somebody who was not present at the meetings but who is just reading the minutes, could that be recorded in some way?

Professor Leith: Perhaps we could provide a list of action points and when they were resolved.

Lady Rice: We could certainly try to do that.

Jackie Baillie: I take it that you got that information.

Lady Rice: Yes.

Jackie Baillie: That is good.

Your report includes a helpful comparison between OBR and Scottish Government forecasts on residential and non-residential LBTT. Although Mr Chote—diplomatically—did not want to comment on whether his forecasting is better, I note that the OBR's forecast for 2016-17 is considerably lower than the Scottish Government's. There is a substantial difference of £42 million in the residential forecasts. Is there an explanation for that?

Professor Leith: One reason is that the OBR incorporated more of the recent outturn data on residential and non-residential LBTT than the Scottish Government did. Another point is that the Scottish Government smoothes the past few years of non-residential transactions in formulating the base on which it projects forwards, because there is variability from year to year in the non-residential market, and that smoothing tends to reduce things. However, as Robert Chote indicated, the differences are not statistically significant. Given the uncertainties that are attached to the forecasts, they are much of a muchness.

Jackie Baillie: I know, but when I think about having to forego £42 million from the budget, that is quite significant in monetary terms.

Professor Leith: Yes, but statistically speaking, it is not.

Jackie Baillie: You said that the OBR included outturn data. Is that not key in measuring what is likely to happen?

Professor Leith: There are different approaches. We are talking about the part-year outturn data. For the landfill tax, the Scottish Government forecasters used the two quarters of data that we have on landfill as the base on which the forecast is pushed forward.

For the LBTT forecasts, the forecasters used the last complete year of outturn data and not the part-year data that we discussed previously. We have recommended that, particularly in a year such as this one when a large part of the outturn data has been revealed, it might be useful to update the forecast.

Jackie Baillie: I was not quite sure where Gavin Brown got some of his figures on additional LBTT from. At the top of page 11 of the forecasting methodology paper, the Scottish Government's forecast for revenue, which does not take account of behavioural change or forestalling, is in a range of £45 million to £70 million. Those are the Scottish Government's starting figures. The fact that the forecast has now dropped to a range of £17 million to £29 million is of considerable concern. I accept all the analysis that the Government has done to get there, but I wonder whether the budget includes the lower or the higher figure for the revenue that will be generated.

Professor Leith: The lower figure is the ultimate forecast.

Jackie Baillie: We will find the £17 million to £29 million estimate in the budget, not the £45 million to £70 million estimate.

Professor Leith: That is my understanding.

Jackie Baillie: I have two more points, but I will be quick, convener. The first is on non-domestic rates. Paragraph 5.14 of the SFC report says that it is not your job to report on the scale of the forecast errors. Out of curiosity, I ask how big those errors are.

Professor Leith: They are relatively small. Buoyancy is essentially a forecast of the increase in the stock of rateable value properties. Revenue is generated by the stock, not that increase. Pretty bad forecasts can be made of the increase, but the stock is fairly constant, so the revenue forecast error is usually relatively small.

Jackie Baillie: It is helpful to understand what you meant.

I heard what you said about revaluation appeals happening at the beginning of a revaluation process, but is it not the case that when a person buys a property, they have six months in which to ask for a revaluation? Therefore, throughout the year and not just at key points, revaluations could occur—that would depend on the number of house sales.

Professor Leith: The revaluation data to which we had access suggested that those effects were relatively small but that the revaluation cycle was a great deal more significant.

Jackie Baillie: Finally, the Scottish rate of income tax is tantalisingly mentioned under discussions on paper 6 in the minutes of your 23 September 2015 meeting, at page 57 of the SFC report. The SRIT is not mentioned at all in your report other than in those minutes. I am curious. What do you see the commission's role to be, given that the OBR carries out a lot of the assessment?

Lady Rice: We will have a role. In early 2015, we were given briefing on the nature of the Scottish rate of income tax; we have also joined challenge meetings hosted by the OBR at which the issue has been discussed. Therefore, we have spent time on the tax in the past year when we could and we have become more familiar with it.

Our current job is to scrutinise or assess forecasts that the Scottish Government makes. If the Scottish Government produces a forecast on SRIT, we will have a role in relation to that forecast.

Richard Baker (North East Scotland) (Lab): I thank members of the Fiscal Commission for their report. I will cover one area: the capacity for the models that have been developed to take account of variations in regional economies, so I will be quite parochial. Lady Rice knows well the north-east economy, which is going through a particularly tough time that is different from the position of the rest of the economy. I imagine that that will have a particular impact on LBTT, for example. Given that major difference in what is quite a big economy—it has an impact across the country—to what extent can the models take account of that scenario?

Professor Leith: The current forecasting models do not provide a regional breakdown at all.

Richard Baker: Last year, the committee had evidence that the Aberdeen housing market will not return to its 2015 position for another five years. We also heard about the massive impact on non-residential property. If that comes through in the outturn figures for the current year, will it be possible to factor the impact into future models? You will have to tell me whether this is right, but that could have a significant impact on future forecasts, could it not?

Professor Leith: The current forecasting approach employs a distributional model of housing transactions across the various price bands for the whole of Scotland. A similar distribution could be constructed for a particular region that it was thought was going to behave differently from the national average and was going through significant changes, and one could be subtracted from the other in producing the forecast. There are ways of incorporating such regional effects if they are felt to be important.

Richard Baker: The current forecast does not take account of what is happening in the north-east's economy.

Professor Leith: No.

Richard Baker: I find that quite surprising, because we know what is happening and there is evidence about the drop in the number of transactions. I would feel quite surprised if that had no effect on the numbers for next year.

Lady Rice: I appreciate that point; perhaps we could take it away for consideration. A related point is that additional properties, particularly in the buy-to-let market, are big in the north-east, so we need to think about the new tax from that perspective. We will take that away.

The Convener: That concludes questions from committee members but I have some more to ask just to finish of the session.

In answer to Jackie Baillie's question, you talked about outturn data and the fact that the 2015-16 data does not feed into the forecast for LBTT, although it does for the forecast for landfill tax. I think that you said that the issue appears in your report, but I do not see anything in the report to explain why that happens.

Professor Leith: It is a choice on the part of the Scottish Government forecasters, but we recommend in our report that, perhaps particularly in years in which a significant span of outturn data exists for the year, it is factored into the forecast.

The Convener: Good. You clearly agree that it should be factored in. That was the one thing that I wanted you to clarify.

Recommendation 2 in the annex to the methodology document says:

> "The Scottish Government has investigated developing alternative models for forecasting house prices and transactions volumes. Examination of the requirements to develop new techniques suggests that it would take a significant period for SG economists to produce output to a sufficiently robust quality standard. As such, the view was taken that forecasts using these methodologies could not be utilised within this Budget cycle with any degree of assurance. There is the potential to develop such methodologies over the longer term, with a view to utilising these in a future forecasting cycle."

What sort of time period are we talking about? It is not of concern that it would take a "significant period ... to produce output to a sufficiently robust quality standard"?

Lady Rice: That is the Scottish Government's response to us pushing it on the issue. It says that we could look at it, but it would take a while to develop and build the expertise in-house—which seems to be a word that is missing—in order to do that. The Government could give you a sense of the timeframe.

In my opening remarks, I suggested that one of our concerns is that the Government needs to enhance its forecasting capability.

The Convener: Are you not concerned that there is no timescale for producing such an output to the "sufficiently robust quality standard" that the recommendation suggests?

Lady Rice: Yes. Of course we have only just seen the document so we have not had any further discussion with the forecasters about what they mean.

The Convener: How soon would you want to be able to see that work? How soon would it be practical to achieve it?

Professor Leith: Whether research works out the way that you hope it will work out is always hit or miss.

The Convener: It is just that the response looks to be saying, "How long is a piece of string?"

Professor Leith: The initial round of modelling that we are looking for should not take years and years.

Lady Rice: We would like work on it to start. That is the most important thing.

The Convener: Yes. The Government needs to acknowledge that there is an issue. I understand that, but it is one thing to acknowledge something and another to actually deal with it.

Jackie Baillie: I have a final supplementary on your point, convener. I am not quite sure whether I got this right. Lady Rice, did you say that you have only just seen the response to your recommendations from last year's report?

Lady Rice: We have only just seen the table in the document, but we have discussed the issue in our meetings.

Jackie Baillie: I make the observation that it might have been much more useful if you had seen the response much earlier and had been able to challenge it. After all, it relates to last year's report.

Lady Rice: But we have had those discussions in our challenge meetings—they have taken place. What you are referring to is the forecasters' summary of their position.

12:30

The Convener: I have a few more questions to finish with.

Table 5 of the Scottish Government's methodology paper shows non-residential LBTT revenue rising by £10 million annually between 2016-17 and 2020-21, yet there has been a £74 million increase in the forecast in one year. Do you know why that is?

Professor Leith: Are you asking why the revenues in one category increase more dramatically than those in the other?

The Convener: My point is that the figures do not seem to add up.

Professor Leith: The reason for the differential in the trends is that the forecasts for the residential transactions are based on the probability distribution model, whereby as prices rise, more and more houses are pushed into higher tax bands. The figures assume that the Government will obtain the revenues from that.

The non-residential forecasts over the five-year period take the original tax base and raise it by revenue and prices without factoring in any of the fiscal drag that dominates the residential forecasts.

The Convener: I know. It just seems a bit odd that there has been a £74 million increase in the forecast in one year, yet the methodology paper indicates that there will be only a £10 million rise. The two figures just do not seem to add up.

Professor Leith: I am not sure which two figures you are referring to.

Lady Rice: Where does the £74 million come from?

The Convener: There has been an increase in the forecast between 2015-16 and 2016-17 of £74 million, but table 5 of the Scottish Government's methodology paper shows non-residential LBTT revenue rising by only £10 million annually.

Professor Leith: So you are talking about the jump from last year's budget forecast to this year's budget forecast.

The Convener: Yes—it seems as if there has been a huge leap.

Professor Leith: I am sorry; I misunderstood what you were asking about.

What the Scottish Government did for non-residential revenue was smooth the tax base for three years of outturn data before beginning the forecast, but it did not take account of the fact that we would expect prices to rise over that period. Therefore, when it did that smoothing, it was not really aggregating like with like. That would impart a downward bias to the forecast. The Government has removed that downward bias in the new forecast. In addition, prices and transactions are a bit higher than the Government anticipated when it did the original forecasts. The combination of those two things resulted in the increase in the forecast.

The Convener: That is very clear—thank you.

In your report on the 2015-16 draft budget, in relation to non-residential LBTT, you recommended the development of new data sources as a high priority. Since then, HMRC has begun to publish data on commercial property transactions in Scotland. Does the existence of that new data mean that we can now develop a Scottish model rather than having to rely on UK-level transactions for the non-residential forecast?

Professor Leith: Yes. There is a reasonable span of data, so it would be possible to start to do some fairly straightforward modelling work based on Scottish transactions instead of using UK transactions. That is one of the recommendations in our report.

Lady Rice: We would recommend that.

The Convener: That is great—thank you very much.

Are there any further points that you would like to make?

Professor Leith: No; I think that we have covered everything.

The Convener: Thank you very much for your contributions.

We agreed earlier to move into private session at this point, so I will allow members of the public, our witnesses and the official reporters to leave.

12:34

Meeting continued in private until 12:36.

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