The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

FINANCE COMMITTEE

Wednesday 13 January 2016

Session 4

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FINANCE COMMITTEE
2nd Meeting 2016, Session 4

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*John Mason (Glasgow Shettleston) (SNP)

COMMITTEE MEMBERS

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

*attended

THE FOLLOWING ALSO PARTICIPATED:

Paul Johnson (Institute for Fiscal Studies)
Graham Owenson (Scottish Government)
John Swinney (Deputy First Minister and Cabinet Secretary for Finance, Constitution and Economy)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The Sir Alexander Fleming Room (CR3)

Scottish Parliament

Finance Committee

Wednesday 13 January 2016

[The Convener opened the meeting at 09:30]

United Kingdom Spending Review

The Convener (Kenneth Gibson): Welcome to the second meeting in 2016 of the Scottish Parliament's Finance Committee. I remind everyone present to turn off any mobile phones or other electronic devices.

As members will be aware, Richard Baker resigned as an MSP on Monday. I take this opportunity to thank him for his contribution to the Finance Committee, and to wish him every success in the future. We are therefore down to six committee members, at least for today.

Our first item of business is to take evidence on the recent United Kingdom spending review from Paul Johnson, director of the Institute for Fiscal Studies. I welcome Mr Johnson to the meeting and invite him to make an opening statement.

Paul Johnson (Institute for Fiscal Studies): Thank you very much. I have just a couple of points to make in my opening statement. As will have been clear following the spending review, the scale of the cuts that are being imposed is somewhat less—significantly less, actually—than was implied by the Conservative Party's manifesto last May and a bit less than looked likely following the budget last July. That meant that the scale of the cuts that are being imposed on the so-called unprotected departments is somewhat less than we expected beforehand, but it is nevertheless significant. The average cuts to unprotected departments over the next five years are still in the order of 17 or 18 per cent, although the pre-spending review figures suggested that the figure might be as much as a quarter, or even a little bit more.

One of the questions is, why that change, first, since the manifesto and, secondly, since the July budget? Since the manifesto there has simply been policy change. There have been decisions to delay some of the cuts and to increase taxes by around £15 billion, if you put the July budget and the autumn statement together. Secondly—and it is very much a secondary point—there were some forecasting changes from the Office for Budget Responsibility, which gave the Chancellor of the Exchequer some additional room for manoeuvre.

The third point that I would make is that some relatively small changes have made quite a big change to the scale of the implied cuts for the unprotected departments because there is a big gearing effect, in the sense that the unprotected departments are becoming a smaller and smaller fraction of the total, so relatively small amounts of money can make quite big percentage differences. However, I stress that the scale of the cuts, both over the next four years and over the period since 2010, is still substantial.

All of that has been bookended by the fiscal charter. There is a clear rule that the chancellor wants to work to, which is to get into surplus by 2019-20, and he has continued to aim at a surplus of around £10 billion by that date. As I said, it was, in part, some of the small forecasting changes that allowed him a little bit more flexibility than he might have expected. One of the big open questions about the next two or three years is how he will respond if forecasting changes move in the wrong direction, because the fiscal target that he is following through this session of the UK Parliament is very different from the fiscal target that he was following through the previous session. In the previous session, if forecasts changed and if the economy was doing a little bit less well than expected, he could push out his point of reaching budget balance. His current rule does not allow that and, as the Office for Budget Responsibility has said, there is about a 45 per cent chance that he will not meet that fiscal target because of the way that forecasts tend to change.

The big unanswered question following the spending review is about what happens if forecasts change even quite modestly over a three or four-year period. A sum of £10 billion three years out is a tiny number. I know that £10 billion is a lot of money, but it is small change out of £700 billion or £800 billion of spending and taxes and changes much bigger than that will happen in one direction or another. That leaves quite a bit of uncertainty around how he will respond, either on the tax side or on the spending side.

A significant part of the spending review announcements was about partially undoing the welfare changes that were announced in the July budget. The crucial thing to note in that regard is that the announcement undid the changes to tax credits that were announced for this April onwards but made no change at all to the long-run structure of universal credit, which was also cut back in the July budget.

That has two effects. It will protect everyone in cash terms: there will be no losers this April and, in the long run, anyone who is currently on tax credits will be protected. However, all those people who move on to universal credit afresh or who move off tax credits and then after a period move on to universal credit will get less than they otherwise would have done.

The chancellor has therefore managed to save as much money as he hoped to save in the long run, without hitting people in cash terms in the short run, which might tell us something about how he might treat his fiscal charter. The concomitant of that is that, in essence, he has abandoned the welfare cap that he put in place just a year ago. The cap will be broken in each of the next three or four years and then will be met only by a whisker—even that will be with some interesting accountancy—by the end of the parliamentary session.

Of course, a whole set of other things were going on, but those are the big headlines, as it were, from what we found after the spending review.

The Convener: Thank you for that account, which is greatly appreciated.

We have copies of your comments of 26 November on your post-autumn statement briefing. We also have copies of the preceding IFS briefing, "The Outlook for the 2015 Spending Review". We will be asking about those as well.

In your outlook paper, I was interested in the section entitled "The total departmental spending envelope", in which you talked about departmental expenditure limits and annually managed expenditure. You said:

"AME will grow by 4.1% in real terms between 2015-16 and 2019-20. This means that DEL will need to be cut by 3.2% over this period to keep to the government's total spending plans".

I am not too concerned about the percentages, because things have changed a wee bit since the review announcement. However, the general trend is towards AME rather than DEL. What does that mean for the stability of the public finances?

Paul Johnson: There are a couple of big things going on in the AME numbers. One is that, over time, we are seeing a significant reduction in the fraction of national income that is devoted to working-age welfare. I cannot remember the exact timing, but I think that by the end of this parliamentary session the proportion will be at its lowest level for something like 30 years. In terms of the AME numbers, the fraction of national income that goes to working-age welfare is set to fall quite significantly, certainly between 2010 and 2020.

Two other things are driving up AME. One, of course, is pension-age welfare. The number of people over pension age will increase by 2 million over this decade, so we really are in a position in which demographic change is having a significant effect. That is the case right across the public finances. If we look at spending on social care and health and spending per capita across a range of things, we find that demographic change is having a big effect—it is clearly having a big effect on the AME numbers. In addition, the average pension entitlement among people who are hitting pension age is continuing to increase, relative to the oldest pensioners.

Secondly, although interest rates are very low, debt is continuing to grow. Therefore, the bit of AME that is debt interest spending is growing as debt grows, although it is not at a historically high level.

You asked about the impact on the stability of the public finances. I would say two things in response. We are more dependent than we otherwise would be, because of the stock of debt, on what happens to interest rates and inflation. The amount that we have to pay for the part of the debt that is index linked—it is some £200 billion or £300 billion—depends on the rate of inflation. If the rate goes up, we clearly end up spending more.

As it happens, over the last two or three fiscal events, inflation expectations have gone down, which has given the chancellor a windfall. That will not be true every time; it will happen in the opposite direction at some point, which will potentially create challenges.

The basic interest rate matters a bit less, because the stock of debt is not affected by the rate that has to be paid on new debt. Over time, the debt nevertheless rolls over so interest rate increases will have an effect on the public finances. There has been a positive shock over the last few fiscal events, but at some point it will become a negative one.

In the longer term, the increased spending that is driven by an ageing population is not something that will create uncertainty in the public finances, because we can foresee it with a considerable amount of certainty; rather, it is something that will create less space for other spending.

The Convener: In your remarks on the post-autumn statement on 26 November, you said, referring to the chancellor, that

"He's going to need his luck to hold out. He has set himself a completely inflexible fiscal target—to have a surplus in 2019-20."

You also touched on that in your opening remarks this morning. Last week, the chancellor said that we face

"a dangerous cocktail of new threats from around the world".

There seems to be an indication, even since the autumn statement in November, that we are heading in the wrong direction. RBS yesterday predicted a 20 per cent market fall and urged people to sell, sell, sell, which I thought—

Paul Johnson: It could be a self-reinforcing policy.

The Convener: Yes—one wonders why people would do that.

You said that if the chancellor were unlucky—that is almost a 50:50 shot—the OBR's prediction is that there is a 55 per cent likelihood that he will reach his target. How likely do you think that is, given what has been said in the last week or so about changes in interest rates across the Atlantic?

Paul Johnson: A lot of the recent news has been new and bad, relative to what we knew less than two months ago, when we had the autumn statement. My inclination is not to build too much on what is still a short period of additional news, although it is all bad. The stock market here has gone down, there are problems in China and the most recent public finance numbers from the OBR are less positive than the ones that it knew about when it made its forecasts for the autumn statement. There is a set of things that are looking less positive than they did two months ago.

I do not know how big a difference that will make to the OBR's forecasts in March. It will be difficult to decide whether the recent news is sufficient to make a significant change to its longer-term growth forecasts. If there is such a change—and the change would not have to be very great—the fiscal rule will be much harder to meet. I do not have the numbers in front of me, but growth forecasts would not have to change by more than a few tenths of a percentage point each year for that to mean that, on the current set of policies, we would not meet the target of a £10 billion surplus.

That leaves a very difficult set of choices for the chancellor. Under those circumstances, does he decide that he needs to cut spending on the police, local government or social services, which he managed to protect in the spending review? Does he need to find some additional taxes from somewhere else? Does he do something much looser on his fiscal charter than he is currently intending to do? Does he just wait for something to turn up? One entirely plausible response would be to say—

The Convener: He could say, "Don't panic. Steady as she goes, and we'll see what happens eventually."

Paul Johnson: Exactly. He could say, "Public finance forecasts have changed in the past three months, and it would be silly for me to make a big change in policy given that we are seeing the forecasts move around a lot. I am not going to change policy at the moment, but if the forecasts are still looking bad in a year's time, I will change policy at that point." He might decide to do that.

09:45

The Convener: In your outlook, you predicted that, in England, there would be a cut of 64.3 per cent in local government grants over the decade. What is that figure likely to be now?

Paul Johnson: I cannot remember what the 64 per cent covered. Essentially, the central Government grant to local government, excluding the bit that is made up of business rates revenue, will fall to close to zero by the end of the current session of Parliament. That is a remarkable change.

Of course, that does not imply a reduction of anything like 64 per cent in the spending capacity of local authorities. It is part of a genuinely revolutionary change—I think—in the way in which local government in England is financed. The position in 2010 was that local government financed approximately a quarter or a third of its spend—I cannot remember exactly—from council tax and all the rest of the money came directly from central Government. A large chunk of that money was revenue from business rates that was taken into central Government and then distributed to local government; it just looked like 25 or 30 per cent came from council tax and the rest came in a grant.

Essentially, by 2020, we will have moved to a position in which 100 per cent of local government spend will be self-financed, with approximately one third from the council tax and two thirds from business rates. The difference is that all the business rates revenue will now go automatically to local authorities, not in the sense that each one will keep all of its own business rates revenue, but in two other senses. First, that revenue will be kept specifically within local government, and, secondly, any change in business rates revenue in any local authority that results from additional business and so on will be kept within that local authority.

The level of business rates revenue that is expected by then suggests that central Government will in fact give local government additional responsibilities, because the scale of the cuts, from central Government's point of view, will not be big enough to create additional real cuts, as it were, for local government. Local authorities will expect to be given additional responsibilities. We did not hear in the spending review—as I had thought that we might—about what those additional responsibilities will be, so we will find out more about that.

Finally, a week or two after the spending review we heard some more details about how the central Government grant to local authorities will be distributed. The way in which that has been happening has changed somewhat. Between 2010 and 2015, broadly speaking, the grant to each local authority fell proportionately in much the same way, so those local authorities that were more dependent on grant suffered more in total. That changed somewhat in the December numbers, and we now have something closer to a similar, proportionate reduction in overall spending power rather than cuts of the same proportion in the central Government grant. That brings us closer to where we were pre-2010.

The period between 2010 and 2015 was significantly harder for those local authorities that were more dependent on the central Government grant—in other words, authorities that are broadly poorer or those in London—whereas the change in 2015 meant that there was more of a spread of spending power across local authorities.

The Convener: I asked about that specifically because the committee has heard in evidence that a similar model should be adopted in Scotland.

You mentioned in your statement of 26 November the £3 billion tax on the payrolls of companies with pay bills of more than £3 million. What impact will that have on those companies? Has there been any analysis of that? The OBR seemed to suggest that it might impact on the wages of employees.

Paul Johnson: In the long run, that is the most likely effect. It is effectively a payroll tax, and it will therefore increase the costs to businesses of employing their staff. In the long run, one would generally expect that to result in a reduction in wages, just as we think that employer national insurance contributions are probably largely incident on the wages of their employees.

The apprenticeship levy clearly has a second significant effect, which is that, because it can be offset against anything that is spent on apprenticeship training up to the point at which the apprenticeship levy runs out, the cost of apprenticeship training to the company is effectively zero. Instead of paying £100 to the Government, the company pays £100 for the apprenticeship. That could have two effects: it could result in a real increase in genuine new apprenticeship training, or it could result in some rebadging and relabelling of activities in a way that qualifies for the money but does not change behaviour enormously in a real sense. We will have to wait and see which of those effects will predominate. It will be nice to get a serious evaluation of that.

The Convener: I move on to welfare, which again you touched on in your opening statement. In relation to disability benefit reforms, your briefing note states:

> "Year after year expected savings from this reform go down."

Why is that?

Paul Johnson: In the initial analysis, particularly of the movement from disability living allowance to the personal independence payment, the Department for Work and Pensions expected PIP to be rolled out much more quickly than it actually has been and, secondly, it expected much bigger savings from the roll-out on the basis of the new medical tests. Neither of those predictions has proved to be robust; indeed, each time a new prediction has been made, it has proved to be equally as unrobust as the previous one. The DWP is finding, first, that it is much more difficult from an administrative point of view to do what it wants to and, secondly, that actually most people who were benefiting from the disability living allowance were, as it might say, genuinely facing the kinds of disability that they said they were.

Why did the DWP get that so wrong? It is possible to understand the reason for wanting to make the policy change. I do not have the numbers in my head, but spending on the disability living allowance rose very fast in the period from the late 1990s through the 2000s. What I think happened was not that there was a huge amount of fraud or that the population got massively more disabled; it was just that the disability living allowance was introduced as a new benefit in the early 1990s. More and more people became aware that it was available and, as they became aware of it, they claimed it. Moving back from that situation, we are finding that, unless there is a significant change in what the DWP is trying to achieve—the personal independence payment does that to an extent, although it still aims to benefit largely the same group that DLA was intended to benefit—there is not the scale of opportunity to reduce spending that the DWP thought that there was.

The Convener: Sticking with welfare, I found it fascinating that you said at your autumn statement briefing:

> "If you thought the announced saving in 2016-17 was £4.4 billion not £3.4 billion you'd be right. The £4.4 billion number was just wrong."

You then gave an interesting quote from the OBR, which talked about

> "the challenge of estimating interactions between HMRC tax credits and DWP benefits in the run up to a fiscal event, where the Treasury's policy costings process does not permit us to call on the expertise of officials across both departments on all measures that might be subject to interactions".

Will you talk us through that a wee bit? It is interesting that the figures seem to be £1 billion out on that—£3.4 billion to £4.4 billion is a significant percentage.

Paul Johnson: The reason why I put that quote in my statement is that that was a part of the process that we had not been aware of. We had not been aware that there was that degree of constraint on the OBR's process of costing. What that means is that, because of budget secrecy, in essence, officials in Her Majesty's Revenue and Customs are not allowed to know what the policy decisions are in the DWP and vice versa. Therefore, the OBR cannot discuss changes to HMRC benefits with DWP officials and vice versa.

An interesting question is whether the OBR should be more insistent about being able to see that kind of information. That is partly related to the lateness of the decision-making process. Another issue might be the capacity of the OBR, which does not, for example, have its own tax and benefit model to run such changes and come up with an independent view of the effects. Sometimes, it has to take on trust the numbers that come from individual departments.

The key thing is that it is surprising that the OBR is not in a position to talk collectively with officials from the DWP and HMRC when the combined effects of the policy measures that are being taken depend on the interactions between those departments.

The Convener: Absolutely. Robert Chote was here last week but, if he had been coming next week, we would certainly have asked him about that. It is remarkable that the OBR is not able to call on the expertise of officials from other departments, given the role that it has. I hope that that ability will be developed; we will certainly ask Robert Chote about that the next time we speak to him.

I have a couple more points to cover before I open up the session to colleagues. In your briefing note and your opening statement, you talked about new claimants receiving significantly lower benefits than they would have done before the July changes. In your briefing note, you go on to talk about

"2.6 million working families being an average of £1,600 a year worse off than they would have been under the current system while 1.9 million will be £1,400 a year better off."

From a quick calculation, I have worked out the differential as being £2.9 billion. In effect, does that represent a £2.9 billion reduction?

Paul Johnson: I cannot remember the exact number, but that is broadly right. There is a £2 billion to £3 billion cut in the universal credit spending relative to the spending that there would have been under the continued operation of the tax credit system. That is precisely what the chancellor was aiming for back in the July budget, and it is driven by the reductions in the work allowances—in other words, the amount that people can earn before they start losing the benefit—as well as the reductions in what people can get if they have more than two children.

Because universal credit is structured in a significantly different way from tax credits, some deliberate changes are being made. On average, universal credit will be somewhat more generous to a group of people in rented accommodation because of the way in which the interaction with housing benefit works. As a consequence of that, it will be significantly less generous to those who are owner-occupiers.

The Convener: That leads me on to the last issue that I want to touch on, which is housing benefit. In your statement at the briefing on the autumn statement, you said:

"There was also one small, but in the long run potentially important change made to Housing Benefit for social tenants. For new tenants only ... housing benefit will be restricted to the equivalent private sector rate. That won't bite much initially, saving £225 million by 2020. Had it been imposed on all tenants immediately it would have saved more than £1 billion."

Will you talk us through the Government's thinking on that and the impact that it will have on finances—and, of course, the individuals concerned—in the long term?

Paul Johnson: The context for that is that spending on housing benefit has continued to rise very strongly over the past five years, despite cuts in the generosity. Although the so-called bedroom tax has had most of the publicity, most of the cuts have affected those in the private sector, in particular by reducing the limit to the 30th percentile of properties in a relatively broad area and only increasing that from 2012 in line with inflation. That means that, in effect, the amount of rent that a private sector tenant can get paid as a proportion of the total rent is falling over time.

The proposal in the autumn statement suggested that the amount of rent that new tenants in the housing association sector are paid should be limited in the same way as it is limited for tenants in the private sector. At the moment, none of the rules that I described affects tenants in the social sector. Obviously, most people's rents in the social sector, including the housing association sector, are not above private sector rent levels, but an increasing fraction are above those levels, particularly if they have new tenancies, which are set at a relatively high proportion of the private sector average rent. A number of those rents will be above the 30th percentile on the 2012 indexed private rent.

10:00

As you said, we estimate that such a housing benefit restriction would save about £1 billion if imposed immediately on all tenants. The Government has decided to do that only for new tenancies, so the savings in the short run are much smaller. At a minimum, one would expect that saving to hit the £1 billion mark over time, as everyone flows through the sector. It is more likely to have a bigger effect than that, because the expectation would be that, over time, average rents in the social sector will rise more than inflation, which is the cap on the private sector housing benefit levels.

A big announcement in the July 2015 budget was that social sector rents will be capped at 1 per cent below inflation, so rents will not rise over the next five years. However, certainly in something like 25 or even 30 of the past 30 years, rents in the social sector have risen more quickly than inflation, so the expectation would be for that to bite more in the long run.

The final point is that there is a question about exactly where private sector housing benefit policy is going. As I said, we have a world in which the amount of housing benefit that I can claim depends on the 30th percentile rent in 2012 in the area where I live. Will that still be the case in 2030? If so, that would be the somewhat odd situation in which I might be able to get most or all of my rent paid in parts of the country but only a small fraction of it paid in other parts of the country, depending on what has happened to relative rent levels. If that were to happen, housing benefit would be almost completely disconnected from the rent that anyone pays. There are reasons for thinking that that might not be a bad idea, but it would be very different from the situation that we have been used to.

The Convener: What if the percentile were to change to, for example, 25 or 35 per cent?

Paul Johnson: Again, that would obviously impact in different directions.

The Convener: Thank you.

I will now open up the session to colleagues round the table.

Mark McDonald (Aberdeen Donside) (SNP): Good morning, Mr Johnson. I think that it would be fair to say that, when Mr Chote was before the committee last week, he indicated the vulnerabilities surrounding the £27 billion uplift or, as he put it, the money that was

"found down the back of the sofa."—[*Official Report, Finance Committee*, 6 January 2016; c 3.]

You, too, seem to have indicated that it would not take a lot for that money to start to ebb away.

Mr Chote said that the chancellor has effectively front loaded the policy giveaways off the back of the uplift, with a view that the revenues would accrue later and smooth things over the five-year period. You have indicated that reductions to the sum might well occur. If there is no ability to skim off the top because the giveaways that have been announced have already happened, will that result in deeper cuts having to take place over the remaining period?

Paul Johnson: I have two points to make on that. First, the £27 billion number annoys me, because it is one of those numbers that is cumulated over four or five years—I cannot remember which—so it is nowhere near as big as it sounds. On the chancellor's target for 2019-20, I think that the forecasting change is about £4 billion in that year, so £27 billion is not quite as big as it sounds.

Secondly, as I have indicated, a £4 billion change in forecast four years out is almost neither here nor there. It is slightly odd for the chancellor to make big decisions about whether to protect the police on the basis of a figure that is probably going to shift around by £4 billion at every subsequent fiscal event.

You are right to say that, if we look at the planned spending cuts and at the implied profile of cuts, we see that they have become much flatter. We are still aiming to get to much the same place as we always were in 2020, but instead of going sharply down and then a little bit up, we are going on a gentle glide path, so the protection relative to previous expectations is coming in those early years. The implication of that is that, if we need to do more in 2019, any change between 2016 and 2017, or 2018 and 2019, will have to become sharper, so it becomes more difficult to achieve steep spending cuts in a single year.

That is one of the consequences of having such an inflexible but stark fiscal rule; it becomes more stark as we get closer. Suppose that, in 2018, forecasts for 2019 change significantly, changes will have to be made quite astonishingly quickly in order to meet the rule. Even one year out, forecasts can change significantly. Therefore, the short answer to your question is that I agree that the relative giveaways were in the early part of the Parliament and that, if forecasts change, it will become more difficult to make the sharp adjustment to meet the target in 2019.

Mark McDonald: Presumably, as you have indicated, if it becomes more difficult to make sharp cuts in a one-year period, the only two options that will be left on the table for the chancellor will be to increase borrowing, which would interfere with his fiscal rule, or to increase taxes.

Paul Johnson: That is the natural implication, yes. There are other things, given the way that accounts work, that can be done at the margins, such as selling off more stuff, but broadly speaking those are the options.

Mark McDonald: Is there a risk that in-year adjustments could be made, or are we at a stage where it is too early to predict that? Of particular relevance to us in the Scottish Parliament is the fact that we rely on the budget being set at the beginning of the year and on that carrying through. Sharp in-year adjustments would obviously have an impact on devolved services, as well as on wider UK services, particularly in terms of our ability to offset that. Even if we were to take on board the powers that are coming, there would still be limitations on how much offsetting could be done.

Paul Johnson: Over the previous Parliament, a number of in-year adjustments were announced as late as the autumn statement for the same year, which appeared to reflect—although I do not know how closely—views about the degrees of underspending that were going on in any case. Those in-year adjustments in a couple of the years of the previous Parliament were quite significant. The way in which the fiscal rule is construed would mean that, if in the autumn statement of 2018 there was a forecast for 2019-20 that had moved such that it looked as if there would be a deficit in 2019-20, it would not require an in-year adjustment in 2019-20—in other words, in the last four or five months of that year—but it would require, at that very late date, a change in the spending expected in the following year. Although I do not think that it would necessitate in-year adjustments, it certainly might necessitate very-close-to-year-start adjustments, and potentially quite big ones.

Mark McDonald: It is difficult to predict with absolute certainty, but I guess that the likelihood—based on the current economic circumstances and the projected future economic circumstances—is that, if there were to be in-year or late-year adjustments for the following year, those adjustments would be more likely to be unfavourable than favourable. Would it be fair to say that?

Paul Johnson: We have only two more months' information than we had back at the end of November, but most of that information has been bad, so I think that that has moved the risks in that direction.

Gavin Brown (Lothian) (Con): You said that, according to the OBR, there is a 45 per cent chance that the fiscal target will not be met. Is the IFS as bold as to suggest a percentage? If not, what is your personal view?

Paul Johnson: I think that the OBR's calculation is based on a methodology that we developed at the IFS, which is not terribly scientific but is a look back at what has happened over the past 30 years. It involves taking each of those 30 years and looking at the forecasts for five years from that point, ascertaining how wrong they were and by how much, then assuming that we are in a similar position now looking five years hence and considering what the likely error will be, based on the errors that were made in the past.

We might think that fewer errors will be made now, because we have an independent OBR—which might be doing a better and more honest job of forecasting—or because we think that we are on a relatively stable growth path that will not change dramatically. In that case, we might make the confidence intervals tighter. Equally, we might think that we remain in very much unknown territory in relation to how the economy is developing, with all sorts of things going on externally, such as the chance of our leaving the European Union. In that case, there might be more uncertainty than usual and the confidence intervals might need to be wider.

I do not know which of those worlds we are in, so to base the calculation on historical experience might be the best that we can do. It is really just historical experience that is telling us that there is that degree of uncertainty, and 45 per cent is probably the best shot that one can have at putting a number on that. It kind of makes sense, too: 45 per cent is just better than evens and, given that the target is a £10 billion surplus and that £10 billion out of £800 billion is a pretty small amount, we would not expect, four years out, anything very much better than an evens chance.

Gavin Brown: We have had bad news recently, given what has happened to the FTSE, concerns about China and so on. Can you see potential positives and opportunities on the horizon, which might help in relation to the 55 per cent likelihood that the target will be met? It is easy to see things that we ought to be concerned about, but are there things that might help us to do slightly better than we are projected to do?

Paul Johnson: There remains a lot of uncertainty, in particular about the degree of unused capacity in the economy. There are certainly forecasters out there who think that the OBR is being unduly pessimistic about the level of unused capacity and therefore about the economy's capacity to grow.

There continues to be a dispute about how much capacity was lost following the financial crisis. The consensus is moving towards the OBR's position, but some people certainly think that there is significantly more capacity in the economy and do not think that we could possibly have permanently lost as much as we might appear to have lost since 2010. That is reflected to some extent in the fact that, although unemployment is still very low, there are still quite a lot of part-time and self-employed workers who might want to move into different roles, and the fact that there is still quite a lot of capacity for companies to invest, for example.

Equally, on the earnings and productivity side, there might still be some catch-up to come. Earnings and productivity have done very poorly over the past five years. The OBR's judgments are in essence based on an assumption that growth will move to a normal place and everything that we have lost over the past five or six years is lost for ever. We would require to get only a bit of that back to make a fairly significant difference to the forecast. If earnings are 1 per cent a year more than is expected, the forecast changes really quite significantly over the medium term.

There are quite a lot of things to which forecasts are sensitive, hence the uncertainty around them. There is still a lot of uncertainty about the direction of the economy, because we are still in unknown territory, and some of the uncertainty will be on the up side as well as the down side.

Gavin Brown: Can you explain something again just for clarity? You said that the figure of £27 billion annoys you. Is that because it is effectively the result of quadruple—or quintuple—counting?

10:15

Paul Johnson: It is one of those. The amount is accumulated over several years, so it is very difficult to make sense of it—if it accumulates over enough years, any number gets big. There is nothing special about a number accumulating over four years—or five; I cannot even remember which it is. The number that the chancellor is aiming at is £4 billion, which is the difference in the forecast for 2019 as a result of the forecasting changes.

Gavin Brown: You have just provided my favourite quote this week:

> "if it accumulates over enough years, any number gets big."

That is one to stick with.

You talked a little about the unprotected departments and the gearing effect. This time round, the changes are quite small because the gearing meant that the cuts were, as you said, substantially reduced. The next forecast is only a couple of months away, so let us use the example of the next autumn statement, which is a bit further away. If the opposite happens—if there is movement of the same magnitude in the opposite direction—is there a likelihood that the gearing effect could work in the opposite direction?

Paul Johnson: That is the big question about the next two or three years. The obvious arithmetical answer to the question is yes, that is what would happen. On whether I really believe that, if that happened and the chancellor needed to find £10 billion of additional cuts, he would move back to whatever that would require, such as a 20 per cent cut in police funding, an additional 10 per cent in local government funding and so on, the more realistic answer is that I do not know. It would be a strange world in which what one thought was the appropriate funding for some of those core public services bounced around by a significant amount as a result of what are relatively small forecasting changes. That would be an odd kind of world and I think that the chancellor would try to avoid doing that, by either raising taxes, finding some other changes in the accounting or putting his fiscal rule out further.

In a way, that would appear to be a residual. If the chancellor were to say, "I will not put up taxes further, I am absolutely committed to my fiscal rule and I will protect the departments that I have said are protected", the unprotected departments would be the residual—they are the things that would suffer. If the chancellor found himself in that position, he would face some of his biggest political and economic choices, and I do not know quite how he would jump. Arithmetically speaking, if those other things are fixed, that is where the adjustment would have to be made.

It is worth saying that some quite significant tax rises were announced in July and in the autumn, most of which were not in the Conservative manifesto, so we have seen some willingness to raise taxes and perhaps there will be further willingness to do that—I do not know.

Gavin Brown: You just mentioned tax rises, so let us move on to one of those, which is the supplementary charge on stamp duty land tax for second or additional homes. Has the IFS done much work on the potential behavioural impact of that charge? Could it impact on the market more widely than affecting only second homes? What work have you done on that?

Paul Johnson: We have not tried to—and I do not think that we could—estimate what the effect of that will be on house prices, for example. I will say two things about the charge. First, the rationale that has been given—that the tax system treats those who buy to let significantly better than it treats owner-occupiers—is not a terribly good one. I just do not think that that assumption is true: owner occupation is still relatively favoured in the tax system.

There could be a much better rationale. If the Government wants to increase owner occupation rates for whatever reason, it should consider one of the factors that are reducing owner occupation, which is that there is a group of people in the population who are very asset rich. They are mostly people over the age of 50, who may have bought a house some time ago and paid off the mortgage, and who have done relatively well in occupational pensions and so on or have inherited something.

They are competing in the housing market because they want to buy a second house, which they have seen has been a very good investment over the past 30 years. That is pushing up prices further. Generationally speaking, that is disadvantaging younger people who want to get into the housing market. From an equity point of view, we would rather that home ownership was spread out across that population. We therefore want to find some way of disincentivising or discouraging people from moving into the housing market as second-home owners. That seems to be a coherent argument. It is not the argument that the Government put, but I think that it is a more coherent one.

It feels slightly odd to be protecting those who are already second-home owners in this market. The measures will effectively only penalise those who want to move into being second-home owners and, broadly speaking, it will leave those who have already benefited protected.

Gavin Brown: But you have not had the opportunity to look into the behavioural impact and you are not planning to do work on that.

Paul Johnson: No. That would be quite difficult, frankly.

Gavin Brown: I have another slightly difficult question to ask. In your view, when will interest rates go up?

Paul Johnson: I do not know. Seriously, it is not part of our remit to consider that. We try not to make forecasts.

Gavin Brown: Fair enough. Thank you.

Jackie Baillie (Dumbarton) (Lab): I have only a small question, as most of what I was going to ask has already been covered.

I wonder whether I might explore the matter of oil prices with you. In particular, both the OBR and the Scottish Government's own "Oil and Gas Analytical Bulletin" have overestimated the price of a barrel of oil. That has significant consequences for the economy and for the budget, I would have thought.

Given that, yesterday or the day before, Morgan Stanley was predicting a price of $20 a barrel, at what stage does the OBR reassess its estimates? How does that feed into the process?

Paul Johnson: The estimates for direct revenues from the North Sea are pretty close to zero already, I think. I do not think that the immediate impact of any changes on those revenues will be great.

The second question here—which is one of the big questions facing the chancellor in March—is whether he is going to take advantage of the situation to increase tax on petrol, for example. The price of a litre is now at its lowest level in real terms for some considerable time.

I note that the policy statement in 2011 or 2012 described a balanced tax system whereby, if prices were high, excise duty would not be increased, whereas, if prices were low, they would be increased. That would trigger an increase in petrol taxation. I wondered whether we might see that in the autumn statement, but we did not. I am now wondering whether we might see that in the budget—I do not know whether we will. Given the other things that we have been saying about the uncertainty around the public finances and so on, that at least is an obvious option for the chancellor.

The position provides something of a boost for other parts of the economy. If people are spending less on petrol, they might well be spending more on other things. As for the way in which the OBR considers the matter, there was a moment when people were saying that, because petrol prices had gone up and we were getting more VAT on petrol and so on, that ought to be good for the public finances, but the OBR came back firmly and said no, that was not true, as the money that people were spending on petrol was not being spent on other things. Clearly, the reverse is also the case.

It comes as a surprise to a lot of people that the OBR did not account for the fact that there seems to be a strong correlation between oil prices going down and poor performance in the stock market, which we might have expected to go in the other direction. That appears to be associated with the drop in demand in China and some other countries, which has created the fall in oil prices and in share prices for oil-exploring companies and so on, with a negative knock-on effect—rather than a positive knock-on effect, as most models would have said we would have previously.

Jackie Baillie: I am curious about what you think would be the greatest risk you would face if you were chancellor. We know about oil prices and fluctuating markets—you presented us with a picture of doom and gloom almost to condition us for what is to come. What is the greatest risk that the chancellor faces?

Paul Johnson: My guess is that the risk that he would not want to have to deal with would be our leaving the European Union. The uncertainty of the impact of that on pretty much every aspect of the economy would be very tough for the Treasury to deal with. I do not know what the effect would be in 10 years, but I think that in the short run the effect would be quite a lot of volatility in one direction or another. The chancellor would not want to face dealing with that risk within the current set of fiscal frameworks and given the current set of forecasts.

John Mason (Glasgow Shettleston) (SNP): We have covered quite a lot of ground already, and I just want to go back to the 3 per cent on stamp duty land tax in the UK and on land and buildings transaction tax in Scotland. Gavin Brown asked you about that as well, and you said that it was ill designed. The concept is to protect existing owners. What is an alternative to that? Would doubling council tax if you have a second home be an alternative?

Paul Johnson: Yes. It depends what you are trying to achieve, but if you want to increase taxation on owners or occupiers of second homes, the obvious approach would be to do something with council tax rather than with a transaction tax.

I think that the chancellor is trying to achieve what I tried to set out earlier, which is about changing the balance of power in the market between generations, as much as anything else, or certainly between those with substantial assets and those with fewer assets. Part of that ought to be about increasing the cost of owning a second home as well as the cost of buying it. You can most clearly reflect the cost of owning it through council tax. You might also think that there is something more equitable about doing that, in the sense that you would be hitting those who are already property wealthy as opposed to those who merely want to become property wealthy.

The crucial thing is to be absolutely clear about what you are trying to achieve. My problem with the proposal is that it does not achieve a balance in the tax treatment of owners of first properties and buy-to-let landlords, which is what it was described as achieving. It might achieve something else that you want to do, but it does not achieve that levelling of the tax playing field.

John Mason: We still have to explore the measure because it has only just been announced—we will do that later this morning. One suggestion is that it will be very easy for people to avoid the tax and that it may raise very little because people will either incorporate or they will just say that it is their next new home and that they are going to sell the old one, but then never actually sell the old one. Are you concerned about the amount of money that it will raise?

Paul Johnson: I would certainly be concerned about the amount of complexity that it might create for exactly the reasons that you describe. Any kind of incorporation will clearly be benefited by this, as you say. Exactly where the line is between an owner buying a property with a bridging loan while selling their own home and buying a property as a second home outright will create many pages of tax law.

I suspect that the Treasury and HMRC will find a way of raising a reasonable amount of money, but perhaps not quite as much as was intended. I think that they will do that by imposing quite a lot of cost on people; not financial cost, but bureaucratic cost.

John Mason: That is helpful.

The last section of your comments covered devolution—in its variety, not just in Scotland. You specifically mentioned the 12.5 per cent corporation tax rate that is expected in Northern Ireland in due course. Is that just of minor interest to us and the rest of the UK in that it will let it compete with the Republic of Ireland, or is there a risk that it could have an impact on the whole of the UK's taxation income, because companies like Starbucks might go to Belfast to pay less tax?

10:30

Paul Johnson: I think that it might do the latter. It will be a quite a big change to the UK tax system. As you know, we have always had a single corporate tax system. The rate will clearly provide incentives to be registered in Belfast as opposed to in London or Edinburgh.

Again, there will be reams of legislation to try to control such behaviour and activity, and there will be very clever people trying to get around it. HMRC and the Treasury are worried about how it will develop and will keep a close eye on it.

It is also worth saying that if Northern Ireland goes down that route, it will be taking a major gamble with its own budget, because it will cost something like £0.25 billion in the first instance, and I am pretty sure that the Treasury will make sure that Northern Ireland bears that cost. Therefore, there is firstly the question of whether or when it will ever recoup that cost, and secondly the question of how the budget will respond in the meantime to cover that significant up-front cost. The way in which the rate is implemented and how the devolved budget copes with that will be at least as interesting as how firms respond and how the Treasury and HMRC try to stop them responding.

John Mason: In the same section, you mention the fiscal framework and the fact that

"We still don't know how devolution to Scotland will work in practice".

Does that issue have any impact on the UK's finances as a whole or is it a question of, "There may be an extra £100 million to spend in Scotland and £100 million extra to spend in Birmingham"—a purely internal thing? You are mainly looking at things from a UK perspective. Do those issues affect the UK as a whole?

Paul Johnson: Yes, they can, for two reasons.

First, there is the way in which the block grant adjustment is made. If the way in which it is determined in the future is more or less generous to Scotland, by definition it will be more or less generous to the rest of the UK. Obviously the gearing ratio means that it matters a lot more to Scotland, because £1 billion is a much bigger proportion of the budget in Scotland than it is in the rest of the UK. Some of the work that David Bell and my colleague David Phillips have done together suggests that reasonable alternatives could make a difference of £1 billion over a 10-year horizon. However, that is £1 billion that Scotland would or would not get that the rest of the UK would or would not get, so, yes, it is a zero-sum game in terms of how much goes where. That is one part of it.

The second part is more complex and is to do with how, if at all, the framework is designed to compensate the rest of the UK for changes that are made in Scotland. For example, if you were to make a change to income taxes that brought income or people from the rest of the UK to Scotland, would you need to compensate the rest of the UK, or vice versa, depending on what the rest of the UK does? My guess is that we will end up with a framework that does not try to do that, because it is just too hard. However, you might think that there are elements of that in there and, if there were, exactly how that is designed would make a difference.

I suspect that the first thing that I said is more important, though: the actual way in which the block grant adjustment is indexed. David Phillips and David Bell set out three different alternatives for doing that, which result in different amounts of money being distributed between Scotland and the rest of the UK.

John Mason: I presume that, in the long term, if Scotland got a raw deal and we had more poverty here, that would impact on the whole of the UK. I hope that that would not happen in the short term.

Paul Johnson: Yes.

John Mason: Thanks very much.

Jean Urquhart (Highlands and Islands) (Ind): I want to ask about the policies that are set in order to have a reduction in the national debt. Everything seems to be geared towards that, but what happens after that? What is the thinking behind the austerity policies that we are seeing and the vision? The amount was going to be cleared by the end of the previous Government term and there is an ambition to clear it now. A lot of people are thinking that they just have to live through it and then something interesting will happen but, in the meantime, three new food banks are opening every week in Britain. Who looks at the devastation of that?

Earlier on, you talked about the changes to the welfare system, which had to be delayed a bit. I think that they were stopped because of the extraordinary havoc that they would wreak on people at the very bottom end of the income bracket in this country. At what point do you have an opportunity to reflect on that and to challenge the chancellor on some of those policies?

Paul Johnson: Let me take the first part of that question first, which was about what is happening to the deficit and the debt and what the plans are. You are right. The original plan was to have the deficit broadly sorted by now, but the plan now is to get to a balance in 2019. To be clear, the debt will still be around 75 per cent of national income by 2019.

Beyond that, the Government's plan is to run a surplus each year in normal times after 2019. The reason that it would give for that is that even running a surplus at the level that is planned for 2019 every year through to the mid-2030s would bring debt down only to where it was just pre-recession, and that is if there are no further recessions. If there was one additional recession, which we might expect between now and the mid-2030s, debt would still be at the mid-50 per cent level even with a surplus in normal times by the mid-2030s. That would be the thinking behind getting to a surplus and then trying to maintain a surplus over that period.

It is also important to be clear that, over the period even after the 2030s, we will continue to be in a world in which demographic change is putting additional pressures on the public finances. We are not aiming for, and the Government is not looking at, a wonderful period after 2020 in which the floodgates can open and public spending can start to rise significantly. As I understand it, this is not a period of austerity to be followed by a period of plenty.

There are, of course, huge uncertainties about all of that, but that is where the plan is and that underpins why the Government is trying to achieve what it says it is trying to achieve.

The Government would say that that is all terribly important because, if we were to enter another significant recession with debt at 70 or 80 per cent of national income and that were then to rise to 120 per cent of national income as a result of that recession, the consequences of possibly losing access to international financial markets or of big increases in interest rates would be devastating. That is the defence. The issue is really how much weight we put on that potentially devastating outcome.

We have never defaulted on debt, but in our lifetimes we have had to go to the International Monetary Fund. Our economy policy was taken over by the IMF in the late 1970s, and the Government wants to avoid that. I put a very small probability on that risk, but the consequences would be very significant.

That is what the Government is trying to achieve and why it is doing it. There is clearly an alternative that would achieve the same thing while not cutting welfare and other spending quite so much, and that is to increase taxes. Tax is about 36.5 per cent of national income, which is relatively low by European Union standards—certainly by the standards of the EU 15, it is one of the lowest percentages. From an economic point of view, there is nothing to prevent us from having tax at 38, 39 or even 40 per cent of national income. It is a big political and social decision. Where we are on tax now is actually where we have been for the past 20 years or so—around 36 or 37 per cent.

My view is that the big political economy debate ought to be more about what we think the sustainable size of the state, and hence the sustainable level of taxation, is, rather than about whether we can borrow £30 billion or £40 billion every year going forward. I suspect that, in the long run, the associated risk is significant—there are costs associated with increasing tax—which is why the trade-off is so big.

That trade-off is exactly as you described it—there are those who are suffering, particularly from cuts in welfare and, for a group of individuals, the universal credit system will be significantly less generous than the tax credits system. As I said at the beginning, in the longer term context, by 2020, our spending on working age welfare will be at its lowest level for about 30 years, although not our spending on in-work working age welfare, interestingly. In 2020, the universal credit system will still be very much more generous than the family credit system was back in 1997 and, on average, at least as generous as the tax credits system was in 2003. It is important to be clear that the change is a reversal of some of what the previous Labour Government did; it is by no means a reversal of everything that it did with tax credits.

Jean Urquhart: We recognise that there is benefit fraud, but it is always a very small amount compared with the amount of tax fraud or tax avoidance. What discussions are there about companies that are registered in offshore tax havens or whatever? Is the Government frustrated about them? Does it believe that they should be hauled back and that Britain should get the tax that it deserves?

Paul Johnson: That is an interesting question. We might learn quite a lot more about that in the budget, because the Government will have to start responding to the Organisation for Economic Co-operation and Development's work on base erosion and profit shifting, which is looking specifically at how to ensure that companies pay tax in the places where their real activities are.

There is a series of issues there. One is about how we define permanent residence, as it were, for companies, and there are likely to be some changes to that. The Government has indicated that it will want to change that in a way that is likely to mean that we will get some more tax from some of the companies that you will be thinking about.

The second issue—and probably the biggest for the Government—is how it decides to treat interest deductibility for corporation tax. That is one of the areas where the UK system is more generous than the system in many other countries, and is significantly more generous than that which is recommended by the OECD. If the chancellor were to limit that tax deductibility, that would be a big policy change and, actually, a reversal of what he has said in the past, so that might be one of those areas where we do not implement what the OECD says is best practice.

There is a third set of questions around whether we adjust our patent box, which is a lower rate of corporation tax on companies that can show that activity comes from something involving a patent, or adjust it as a result of evidence that the activity that got the patent occurred in this country.

Therefore, a number of questions arise from the OECD proposals that we hope the chancellor will respond to in March.

It is important to be clear here: there are areas in which other countries see the UK as a place where companies go to pay lower tax than they would elsewhere. We have quite a generous patent box regime and a low corporation tax rate, for example. Therefore, not all the money will flow to the UK; other countries will want to repatriate, as it were, profits that are currently booked in the UK. I do not even know in which direction the impact on UK corporation tax would go if all of that is implemented.

10:45

Jean Urquhart: Thank you.

The Convener: Thank you. That concludes the committee's questions, but I have a few follow-up questions to ask. On the question that Jean Urquhart asked, surely there is an issue about competitiveness. If you are running a Starbucks and I want to set up another company in the same market, and you are not paying tax but I am, you obviously have a competitive advantage that skews the market. Taking into account the discussions at OECD level, which I know can drag on for a considerable period of time, what is there to prevent the UK from deciding that any money that is generated by businesses in the UK has to be taxed by the UK?

Paul Johnson: It is to do with the definition of the word "generated".

The Convener: A lot of these places are fixed. A Starbucks, for example, is not going to move around. It is on the high street. If it is generating an income that generates a profit that is subject to taxation, what is preventing the UK Government from taxing the profit generated in that particular area or in the UK itself?

I realise that the issue is more difficult for other companies, but surely it is not beyond the wit of Governments to do that now to an extent, even without an OECD agreement, which would be beneficial.

Paul Johnson: My response about what you mean by the word "generated" was a serious response. That is what underpins the international tax treaties. I do not want to talk specifically about Starbucks—

The Convener: It was just that John Mason mentioned it so I was carrying on from that.

Paul Johnson: That company's profits are taxed elsewhere, particularly in the Netherlands, because that is where the intellectual property is said to sit for the recipe, or whatever it is. As part of legally binding international tax treaties, we recognise that those profits are partly not generated here, but there, and that the tax is paid there rather than here.

There are internationally generated legal constraints on taxation and the OECD base erosion and profit shifting process is trying to adjust to some extent to achieve exactly what you are describing, which is to ensure that more tax is paid in countries where you and I might reasonably think that the profits are being generated.

Part of the answer is that you cannot do it entirely by yourself. You have to do it as part of an international process. None of the companies is claiming that no profits are being generated in any particular place, but a set of international rules determines where that generation is recognised and where it is not, and the rules are not something that a country such as the UK can just tear up by itself; it has to act through international processes.

The Convener: The much-used concept of reasonableness does not really come into play because the recipe for a coffee is not too complex. Most of us could work it out.

Jean Urquhart wants to come in.

Jean Urquhart: Will such change be made easier or harder by the introduction of the transatlantic trade and investment partnership?

Paul Johnson: I am afraid that I do not have a view on that at all.

The Convener: We are really pinning you down.

Moving on to something else, the matter of oil prices was raised by Jackie Baillie. You talked about the possibility in the budget of an increase in taxation. Everyone across the globe pays an internationally agreed price for oil, whatever that barrel price happens to be. Would a tax rise have an impact on UK competitiveness? If there is a higher taxation level on what is paid at the pump and by businesses in the UK, relative to other countries, would that have an impact?

Although the oil price fall has been very damaging in the north-east of Scotland and around Scotland, other industries have obviously benefited from it. Is there a sliding scale in relation to the taxation of oil, whereby a penny increase has an impact in the form of X thousand jobs? Is that a kind of model that the chancellor has and uses?

Paul Johnson: I do not know whether the chancellor has a model.

The Convener: Does the IFS have one?

Paul Johnson: We do not, although you could probably create something like that.

Your point is important. Clearly, in general, lower energy prices are good for economic performance. There are two consequences of increasing taxes on petrol: one is that households have to pay more; the second is that, because the tax is also paid by lorry drivers and van drivers, businesses are paying more. Part of the cost of increased petrol prices is that I have to pay more for my food from the supermarket, because Tesco has to pay more petrol tax as well.

One would have to look at input-output tables to see how much of that, particularly taxes on petrol, impacted on international competitiveness. A lot of the impact will be domestic, in the retail businesses and so on; some of it will be on international business. The much bigger effect would be in relation to other energy, particularly electricity. Costs for heavy industry, for example steel or cement where a lot of energy is used in the production process, are not really determined by petrol taxes, but by other energy taxes, green taxes and so on.

We are increasing those taxes, but we have quite an extensive regime of protection for heavy industry users that are internationally exposed. If we are not very careful about the way those protections are created, there is a risk of driving industry offshore. I suspect that, while it will have some effect, a few pence of tax increase on petrol will have a pretty small effect on those very energy intensive industries relative to the effect that taxes on other parts of the energy sector would have.

The Convener: We have seen that with the steel industry—the relative energy costs being credited as one of the reasons why—

Paul Johnson: In reality I do not think that that was a big part of what was doing it.

The Convener: But it was one of the reasons that were quoted at the time.

Basically, if fuel duty goes up there will be an economic impact on individual households and so on.

Paul Johnson: Increasing taxes has an economic impact. Increasing a tax that is partly paid by business, as petrol taxes are, will have a direct effect on those businesses; that is one of the costs. As I said in answer to one of Jean Urquhart’s questions earlier, you can have higher taxes across the economy, but there are costs to higher taxes. The degree of that cost depends on how well the taxes are designed and where they are imposed.

The Convener: Yes, but that kind of tax obviously has some impact on disposable income and so on.

One of the things that we have talked about in previous years but not yet today is productivity. What is your view about where the UK is going on productivity relative to our competitors?

Paul Johnson: There has been a productivity problem across many OECD countries but, since 2008, productivity has been a greater problem in the UK than it has been for many of its competitors. That followed 25 years of quite good relative productivity performance in the UK.

It is partly the arithmetical effect of our labour market performing much better, so that we have a lot more people employed, but in less productive roles. I am probably repeating what I said in previous sessions, but we do not really understand exactly why that has happened or what will happen in the future.

There seems to be some evidence of improvement, not least that real wages have been growing reasonably well over the last 12 to 18 months. The best projections suggest that they will continue to do so, which is good evidence that there is some underlying improvement in productivity as some of the long-lasting effects of the recession and the financial crisis wear off. I would not, however, put much money on wages continuing to grow at 2 to 2.5 per cent a year over the next four or five years.

The Convener: The Scottish Government said that, over the last decade, Scottish productivity has risen by 4 per cent, relative to the rest of the UK. There is clearly of potential for further productivity growth across the UK.

Paul Johnson: There is certainly potential in the fact that we have had such poor performance over the last several years and we have increasing numbers of people in low paid, low productivity work. The fact that our productivity is well behind international leaders is strong evidence that there is potential.

There are things that we could do to unlock some of that potential, whether that be planning reform, infrastructure—particularly transport—projects, or improving education and skills. All would be good for productivity in the long run. The amount that government can do in the short run—in other words, what would improve productivity in the next year or two—is probably much more limited.

The Convener: In the long run, better education, research and development, infrastructure and so on could lead to significant improvements.

Paul Johnson: Yes, and there are different elements to that. We know with a significant amount of certainty, for example, that building more roads or loosening planning rules would be good for productivity. We know, however, that there is a trade-off environmentally and in terms of the impact on people living close to the additional building. We know that additional house building in growth areas would be good for productivity.

There are also things that we know would be good for productivity, such as improving the education system, where there is less clarity about the right thing to do to make it work better.

The Convener: Indeed. On a final point, where do you see sterling going over the next year? I remember, growing up, that there was always a mantra about the value of the pound. That seems to have become less of an issue.

We had the euro crisis a few years ago, and over the last decade there have been quite significant differences in the value of sterling relative to, for example, the euro. In the 1980s, the dollar value went from $2.40 to $1.07 to the pound and bounced back up to $1.50 or $1.60. It does not seem to be as much of an issue as it was. Where do you see sterling fitting in to the UK's economic objectives over the next year?

Paul Johnson: This is definitely not something that I would want to make any kind of projection on. A lot depends on what happens elsewhere, not just in the UK. What happens in the eurozone particularly will be more important in terms of the sterling/euro exchange rate than anything that happens in the UK. If the eurozone manages to remain stable and we avoid another Greek crisis, the euro will continue to do better.

Significant additional quantitative easing in the eurozone may weaken the euro relative to sterling, just as quantitative easing here in 2010 weakened sterling relative to other currencies. I would not want to say much more than that.

The Convener: Thank you very much. That has been as always a very interesting session. Are there any further points that you want to raise?

Paul Johnson: No, that was plenty.

The Convener: Fair enough. I suspend the meeting to enable witnesses to change over.

11:00

Meeting suspended.

11:10

On resuming—

Draft Budget 2016-17 (Revenue)

The Convener: Our second item of business today is to take evidence from the Cabinet Secretary for Finance, Constitution and Economy on the revenue side of the draft budget for 2016-17. Mr Swinney is joined by Sean Neill and Graham Owenson from the Scottish Government.

This will be the first year in which the Scottish Government will have responsibility for setting the Scottish rate of income tax in addition to having full responsibility for setting and collecting the devolved taxes. The committee and the Scottish Government are agreed that, going forward, scrutiny of the draft budget will therefore take place over two separate oral evidence sessions. This morning, we will consider the revenue side, and on Monday we will take evidence on the expenditure side of the draft budget at our external meeting in Pitlochry.

I welcome Mr Swinney to the meeting and invite him to make an opening statement.

The Deputy First Minister and Cabinet Secretary for Finance, Constitution and Economy (John Swinney): Thank you, convener, and good morning. I welcome the opportunity to discuss with the committee in the first of our two sessions the revenue measures that are associated with the 2016-17 draft budget. In the budget, the Government proposes a Scottish rate of income tax for the first time. I am grateful to all the individuals and representatives who have contributed to the discussions on the Scottish rate that have taken place at the Finance Committee over recent months.

From April 2016, the UK Government will reduce the income tax rates that are payable by Scottish taxpayers by 10p, and a rate agreed by the Scottish Parliament will replace that. I am proposing a Scottish rate of income tax of 10 per cent. The decision to set the rate at 10 per cent has been influenced by the limited nature of the income tax power that is currently available to the Scottish Parliament. The power only allows a single rate to be set and then applied to all three income tax bands—basic, higher and additional. That means that any increase would necessarily have inflicted an additional tax burden on lower income tax payers. I could not support that at a time when those people are already being adversely affected by the austerity programme of the United Kingdom Government.

For the Scottish taxpayer, the proposed 10 per cent rate is equivalent to the 10p reduction to be applied by the UK Government. That means that the overall rate of income tax for Scottish taxpayers will remain the same as that paid by other UK taxpayers in 2016-17. The proposed 10 per cent rate is also revenue neutral for the Scottish Government's budget. The amount of tax that is raised by the Scottish rate of 10 per cent will be equal to the reduction in the Scottish block grant. During the transitional years for the Scottish rate, there will be no reconciliation of the actual amount of Scottish rate of income tax that is collected against the OBR forecast.

This is the second time that I have set out proposals for the devolved taxes in the draft budget. I plan to maintain the rates and bands of land and buildings transaction tax at existing levels in 2016-17. That will ensure that 93 per cent of home buyers will pay either less than under UK stamp duty land tax or no tax at all in the year ahead, and it will ensure that Scotland remains an attractive and competitive location for business investment.

In order to ensure that opportunities for first-time buyers to enter the market in Scotland are as strong as possible and to make certain that tax changes elsewhere in the UK do not make it harder for people to get on to the property ladder, I will seek Parliament's approval to introduce an LBTT supplement on additional homes. I welcome the committee's call for evidence on that measure and I look forward to engaging further with the committee on the issues once the legislation is before Parliament.

I also plan to increase the rates of Scottish landfill tax to £84.40 per tonne at the standard rate and £2.65 per tonne at the lower rate. That will ensure that the tax burden is increased in line with inflation and address potential concerns about waste tourism by maintaining parity with rates in the rest of the UK. The credit rate for the Scottish landfill communities fund will remain at 5.6 per cent in 2016-17.

The Scottish and UK Governments have agreed a provisional one-year block grant adjustment for the devolved taxes in 2016-17 of £600 million. The Scottish Government's forecasts for the devolved taxes have again been independently reviewed and assessed as reasonable by the Scottish Fiscal Commission. In total, we forecast that the two devolved taxes will raise £671 million in 2016-17. For the first time, we have also published five-year revenue forecasts for the devolved taxes in order to provide transparency over a medium-term assessment of Scotland's devolved public finances.

I welcome the challenge that the Scottish Fiscal Commission brings to bear on the Government's forecasts, and we will respond by improving the robustness of our forecasting methodologies over the next year.

On local taxation, we have provisionally set the non-domestic rates poundage at 48.4p, which matches the 0.8 per cent inflationary increase in the English rate. We have also provisionally set the large business supplement, which is levied on properties that have a rateable value of more than £35,000, at 2.6p.

In addition, we propose to limit renewable energy generation relief to schemes that incorporate community ownership and to reduce the levels of empty property relief. For empty industrial property, 100 per cent relief is retained for the first three months of the property being empty, after which time the proposed level of relief is 10 per cent. For standard commercial property, 50 per cent relief is proposed for the first three months of the property being empty, after which the level of relief is 10 per cent.

We have committed to review the non-domestic rates system to ensure that it minimises the barrier to investment, is responsive to economic conditions and supports long-term economic growth and investment. We will confirm further details in due course.

I look forward to answering the committee's questions.

11:15

The Convener: Thank you for that opening statement. The first thing that I want to ask about is the Scottish rate of income tax. The Scottish Government's decision on taxation levels is broadly in line with what we heard from the majority of people who gave evidence to us. For example, the Scottish Trades Union Congress's view was that,

"having been through an historically unprecedented collapse in real wages over the past five years, 2016-17 is not the moment in which to increase taxes on the lower paid."—[*Official Report, Finance Committee*, 30 September 2015; c 7.]

It also said that the SRIT is clearly a "regressive" tax.

Have you looked at behavioural responses in the context of taxation? One of the issues that the committee has deliberated on, particularly given the evidence from David Bell, is the impact of potential behavioural responses on the part of taxpayers. It is clear that that will be an issue in the years ahead, but as far as this year is concerned, has the Scottish Government carried out any analysis of potential behavioural responses to the SRIT?

John Swinney: The first thing to say is that it is important when we consider tax measures that we do as much as possible to develop our thinking and our methodology on behavioural responses.

That is a general observation in relation to the tax powers that we will now exercise.

On the Scottish rate of income tax specifically, the analysis in that respect has been looked at by HMRC and the Office for Budget Responsibility, which have developed behavioural analysis in relation to the UK income tax system, over which the UK Government has had control for many years. We have had access to and considered that material, although it must be said that the behavioural response—given that the tax rate is the same across the UK—is negligible or non-existent.

The Convener: I understand that. My question is whether, when you decided to set the SRIT at the same level as the UK level, the potential for behavioural response was taken into account. Obviously, there will be no real behavioural response if the rates are exactly the same. My question is whether the potential for behavioural response influenced you. Given that 1 per cent of taxpayers pay 20 per cent of the tax, that will be an issue in future. The point about the SRIT is that the 10p rate applies across all bands. I just wonder whether, in general, there was any consideration of behavioural responses before you decided on the level at which to set the SRIT.

John Swinney: In my decision on the Scottish rate of income tax, I was mindful of the fact—indeed, it was my primary consideration—that, because the lockstep exists, if I increased the SRIT, I would have to increase the tax burden on lower-income individuals. If, in your inquiry about behavioural responses, you are asking whether I thought that it was appropriate to increase the burden on those individuals, the answer is that I did not think that that was appropriate. That was my primary consideration in coming to the decision.

The Convener: I take it that, with the new taxes that will come in from April next year, you will look more at behavioural responses of different income groups.

John Swinney: Yes.

The Convener: Because you will not have the lockstep that you mentioned, you will have much more flexibility.

John Swinney: That is an area that I will be working on. You mentioned Professor David Bell earlier. He has published some material on behavioural responses, and my officials are undertaking some work on that because more flexibility is inherent in the income tax variation powers that will come through the Scotland Bill and it is important that, when Parliament makes its judgment on these questions, it is informed by the most advanced behavioural analysis that we can develop.

The Convener: The reason why I am pushing you on this a wee bit is that there has been all sorts of evidence that, although a difference of 1 or 2 per cent might not make any real difference to behaviour—for example, if it is imposed on higher earners a year from now—a higher difference might have an impact. What is of interest is the level at which that increase would start to have an impact.

On the same theme, are you aware of any impact in relation to the identification of Scottish taxpayers? The Scottish Government has made it clear that there will be no change in the year ahead, but is there any evidence that people are identifying as Scottish taxpayers more or less than would be anticipated? Do we have any information at this early stage on the minority of people who tend to be more mobile?

John Swinney: Nothing is really emerging on that. The expectation was that we will be dealing with about 2.5 million individual taxpayers. That is roughly the number of letters that have been issued by HMRC to identify Scottish taxpayers. I hope that members have all received those letters. The letter was anxiously awaited in the Swinney household to see whether the system was working properly, and it duly arrived.

Nothing that we are seeing so far suggests that the system is delivering any form of differential pattern; what was expected to come back has come back. HMRC was unclear—understandably—about what the dispatch of the letters would generate in terms of traffic and communication, but that has been significantly lower than would have been anticipated. The last information that I had was that the amount of traffic had not been significant and I have not heard anything that would change my view on that.

The Convener: On tax reliefs, the Revenue Scotland and Tax Powers Act 2014 introduced a general anti-avoidance rule in respect of the devolved taxes. The GAAR is broader in scope than the UK general anti-abuse rules and its focus is on tax avoidance rather than abuse. However, as the SRIT will not be a fully devolved tax, the Scottish GAAR will not apply to it. Is that a concern at all?

John Swinney: I would not say so. The income tax power that we have relates to non-savings and non-dividend income, so it is a much more tangible and identifiable level of income that must be considered as part of the process. Non-savings, non-dividend income tax is at the end of the spectrum where it is more difficult to avoid and to conjure up ways of getting round, so I do not think that a difference arises from the fact that UK legislation will determine those points.

The Convener: Thank you for that. On the block grant adjustment, which is of paramount importance, you have made it clear that the indexed deduction per capita is the best way to proceed. We have taken significant evidence on that and discussed it in committee and I think that we all agree that that seems to be the fairest method.

However, you mentioned in your opening statement the £600 million one-year agreement on the adjustment in relation to devolved taxes for the year ahead, and I am curious about how that figure was arrived at. As you mentioned, the Scottish Government has forecast revenues of £671 million from LBTT and landfill tax, but the OBR has forecast £627 million. The mid-point for those forecasts is £644 million. I wonder how the adjustment of £600 million was arrived at.

John Swinney: It was arrived at through discussion between the Chief Secretary to the Treasury and me. To be fair to him, one of the issues that he was mindful of was that he did not want me to be in the position that I was in for the previous year whereby, in essence, I had to present a budget to Parliament without knowledge of the block grant adjustment. He was keen to agree a definitive number on which I could base a budget, and I am grateful to him for that understanding.

On how we arrived at the agreement, I do not have the exact wording in front of me, but I stress that it is a without-prejudice agreement that will be reviewed in the light of outturn data after 2016-17. It enables us to set a budget with some confidence around the number. The adjustment was arrived at by looking at the forecast that had been produced by the Office for Budget Responsibility and then looking at the block grant adjustment for 2015-16, which is £494 million. That number clearly had to be inflated or indexed—whichever word we want to use—and we looked at different ways of doing that, such as by increases in the number of transactions or by values. In looking at a number of options, we settled on £600 million as a without-prejudice number to enable us to make progress on these questions. We had the benefit of having outturn data for 2014-15—if my recollection is correct, the figure was £580 million—and we looked at the different factors within that and arrived at a number.

I cannot present to the committee a scientific analysis of how we got to £600 million, but a range of numbers were discussed and we agreed that figure to enable me to make progress in setting the budget with a definitive block grant adjustment for the financial year. It can be reviewed once the financial year is complete.

The Convener: Thank you for that. The committee raised concerns about the lack of transparency regarding adjustments to the block grant arising from the devolution of further powers, and the Scottish Government consequently agreed to a number of changes to the written agreement, saying that it would

“ensure that the Finance Committee is kept informed of progress on any agreement, or change to existing agreement, with the UK Government on adjustments to the block grant arising from the devolution of further powers.”

I am not sure that that has really happened in the process.

John Swinney: I acknowledge the issue and the agreement that was arrived at with the Finance Committee. Here, we begin to stray into the territory of the fiscal framework, because it has to be considered by the Scottish Parliament, which has to be satisfied with the framework’s contents. The agreement that you mentioned is very much in my mind, as is what will be implicit in the understanding to ensure that the committee is satisfied by the arrangements around future block grant adjustments. The example that we are talking about, like the one for 2015-16, was a one-off agreement around specific numbers and no real process was put in place. However, for the establishment of the fiscal framework, there is a scrutiny process that the Parliament must go through, and it must involve the Finance Committee in some form.

I stress that, at this stage in the proceedings, my preference would be to have a fiscal framework and a block grant adjustment mechanism that we are not constantly revisiting, as that will give us confidence and clarity about how it is operating. However, if it is revisited, the Finance Committee will have to be closely involved and consulted about the issues.

11:30

The Convener: It is quite clear that there has been significant growth in sales of lower-priced houses and a boost to that market. The committee’s budget adviser, Professor McEwen, has stated that market data shows that there has been a significant reaction to the introduction of LBTT at the higher end, and a significant reduction in higher-end sales as a result.

That is reflected in the evidence that the committee has taken from witnesses, who have said that there has been a positive impact on the middle and lower tiers of the market, with

“a new lease of life under the new tax regime”

and

“property sales in Scotland for first-time buyers and home movers ... increasing three times faster than the rest of the UK.”

The exact opposite appears to be mirrored in the more expensive households. Obviously that will have an impact not only on the market, making it more sluggish at that end, but on revenue for the Scottish Government. Why is the Scottish Government not considering—albeit that the taxes have been in place only since April last year—a change in the tax level for those more expensive houses?

John Swinney: First, I am confident that the evidence shows that, in general, the tax take that will come from the devolved taxes will fulfil the requirements of the budget. The shape of that, as things stand just now, appears to be different from what was envisaged, with more taxation being generated through non-residential land and buildings transaction tax and landfill tax than was predicted and less emerging from residential transactions.

The shortfall in residential transactions is broadly comparable at this stage with the level of forestalling that was identified or suggested by the OBR. I accept that there has been an effect of forestalling—one cannot look at the data without seeing that there is a clear impact from forestalling, which in my estimation came to a conclusion in August in terms of the impact on the market.

That is my explanation for the numbers. Overall, we are going to reach the revenue that is required to support the budget, and I suspect that we will exceed that total. Secondly, the mix will be different, and thirdly, the effect of forestalling is tangible in the figures on residential transactions.

In the final part of your question, you asked why the Government has not revisited those things. I looked at quite a bit of the evidence that the committee had taken—it was helpful to have that—and my assessment was that individuals in the sector were saying, "Let's just see what an overall year-long position does and then we can revisit that."

Given that the forestalling effect is so tangible, it would be prudent to wait and see the completion of a full year, and perhaps to wait even longer. I would be interested to see what a whole year looks like without any question of forestalling implicit in the system in order to come to such a judgment.

The Convener: That is a very fair assessment of the evidence. Most of our witnesses said that they were not necessarily calling outright for a change at this point, but they certainly wanted the situation to be kept under review because there were some alarm bells ringing. Perhaps a full year's data would be helpful.

The Scottish Fiscal Commission raised some concerns about the available outturn data for 2015-16 not feeding into forecasts for land and buildings transaction tax, whereas it feeds into the forecasts for landfill tax. Why would that be the case? Why would you look at outturn data for one and not the other?

John Swinney: Our challenge with landfill tax specifically is that we have not had disaggregated data, or any way of creating a particularly robust disaggregated data picture, for landfill tax within Scotland as part of the UK landfill tax system. There has been a particular deficiency in that respect. I have the 2014-15 forecast in front of me. The number was about £117 million and I would be surprised if we did not end up somewhere round about £140 million. That is quite a significant difference. I would be the first to accept that we did not have a particularly aggregated base from which to arrive at that estimate. Therefore, seeing the pattern of experience, it would be prudent to take that forward for 2016-17.

However, on land and buildings transactions tax, we have a model that has been built up from granular data based on the property transactions that have been undertaken in Scotland over many years. That much more robust, empirical base of information would enable us to form a judgment on those questions.

Given what I have just said about the significant effect of forestalling, I would be loth to attach too much significance to the outturn position on 2015-16 at this stage, because that could give a distorted picture of what the market would look like.

The Convener: Staying with LBTT, the SFC raised a number of issues. It said:

> "there may be longer-term behavioural responses to the new tax which the current forecasting approach does not allow for."

It recommended that behavioural factors should be included in the forecasting methodology as soon as practicable. However, despite those concerns, the methodology still does not account for any behavioural response.

John Swinney: I am committed to further development work on behavioural responses. We have published the forecasting methodology paper, which the committee will have seen. That goes through in some detail our modelling approach, as well as our approach to behavioural questions. A section on page 11 of the document around land and buildings transaction tax explores some of the questions around behavioural response and forestalling. I am committed to enhancing the regime.

On the particular question of the LBTT supplement, I have applied significant behavioural questions to the assessment of that tax. Indeed, an analysis that took no account of behavioural responses suggested that the revenue generated in 2016-17 could be between £45 million and £70 million. However, once the variety of behavioural responses was taken into account, a more appropriate range appeared to be £17 million to £29 million. I have, of course, settled on £23 million as what we could reasonably expect to be generated by the supplement. Therefore, significant account has been taken of behavioural factors in that analysis.

In this financial year, the effect of forestalling is of some significance. I want to ensure that we do not attach undue significance to the data that comes out of this year, which may be influenced by the effect of forestalling.

The Convener: Thank you very much—the position is clear now.

I do not want to go into the LBTT supplement in any great depth, because we will take evidence on it specifically. However, Professor McEwen has provided the committee with a briefing that looks at the potential difficulties with realising even the £23 million that you have just mentioned because of a host of measures that could be taken to avoid that tax; for example, property could be let through a company, because the supplement does not apply to companies. How concerned are you that what should be a fairly straightforward measure could become quite complex if the Scottish Government has to quickly introduce legislation to prevent such blatant avoidance?

John Swinney: To be honest, as I look more and more at tax questions, I do not think that there is anything simple about tax. If that is the holy grail that we are after, we will have a long search.

I accept that there is a need for us to take care in trying to take forward what, on the face of it, seems to be a simple proposition. We are engaging in consultation on these points. Obviously, the committee will exercise scrutiny and, as always, I will be keen to hear the committee's views. It will be important to consider some of the analysis that is provided to you by Professor McEwen.

We have to ensure that we design a proposition that can meet the purpose that is inherent in the legislation, and that that can deliver the level of taxation that we envisage. We have to ensure that we do not inadvertently take steps that could make that task more difficult.

The Convener: The Scottish landfill communities fund will remain at 5.6 per cent, compared with the UK's rate of 4.2 per cent. What was your thinking behind that?

John Swinney: I have been impressed by a lot of the projects that are supported by that measure. I said that I would set the Scottish landfill communities credit at 10 per cent above the UK rate. However, when the UK reduced its level, I thought that it was reasonable for us to sustain the level of support that we had in place and ensure that the sums of money that are critically important to some community projects can be sustained in the years to come.

John Mason: Good morning, cabinet secretary. We have been considering the issue of whether the Scottish rate of income tax is progressive or regressive. The convener is convinced that it is regressive and I am convinced that it is progressive.

John Swinney: I am glad to hear that there is such unity at the heart of the Scottish National Party members of the committee.

John Mason: We are all independently minded here.

One witness gave us an example concerning someone with an annual income of £25,000 and someone who is on £125,000 a year—obviously, one of those people is earning five times the wage of the other. The witness said that adding 1.5p on the SRIT would mean that the person on the lower wage would pay £216 extra, while the one on the higher wage would pay £1,875, which is eight times more. That shows that, although the tax is not extremely progressive, when the income goes up five times, the tax that is paid goes up eight times, which strikes me as progressive. How would you respond to that?

The Convener: I am tempted to respond.

John Swinney: I am grateful to Mr Mason for inviting me to intrude into this private debate between him and the convener.

I will give an honest and straightforward answer—that is what I always do in committees, but I suspect that it might incur the wrath of the convener this time. I view the Scottish rate of income tax as a progressive power, on the basis of the sort of analysis that Mr Mason has outlined, although I do not have that particular example in front of me. Clearly, people on higher incomes will pay comparatively more than people on lower incomes.

Two issues were on my mind and influenced my decision. The first was that the lockstep would involve increasing tax for people on low incomes. I take the view of the STUC that this is not the moment to do that, as people are finding things hard enough. The second point was that, if I had increased the Scottish rate of income tax beyond 10p, as a percentage of current income tax, the increase in individuals' tax bills would have been greater for those on lower incomes than it would have been for those on higher incomes. On those two grounds, I felt that it was not an appropriate step to take.

John Mason: I understand that and I accept that the majority of witnesses have taken that view.

The Convener: Including the STUC.

11:45

John Mason: Yes. However, NHS Health Scotland argued that even though it would mean taxing people at the bottom end, using that money to help those at the bottom end, both earning and non-earning, could be compensatory and an overall benefit.

John Swinney: There is an interesting and substantial debate to be had here. The issue that would trouble me about what you describe is that it would require a very refined form of targeting to support incomes, and I do not think that at this stage we have the powers that would enable us to have such a refined impact on people's incomes. If I understand the rationale of the argument, it is almost about compensating some individuals for a tax increase that all individuals would have. I would not be confident that we have the powers to put in place such a refined mechanism.

The tax credit debate provides examples of the type of devices that could be taken forward to try to get to that refined proposition. That power is not with us today, and I do not see anything like it being in our range of powers. I may have discussed with the committee before the challenges that I faced in dealing with the reduction in the council tax benefit payments that was put in place by the UK Government. The minute that I went anywhere near the B word—the benefit word—I was in territory that I am not permitted to go into, which is why we ended up with a council tax reduction scheme. I am perfectly entitled, if Parliament authorises it, to reduce people's council tax, so we did that.

However, on having a very refined mechanism of almost compensating certain individuals—crucially, it would be just certain individuals and not all individuals—I do not think that we would have the legislative competence to do that.

John Mason: That is fair enough.

On the Scottish rate of income tax, questions have already been raised about behavioural response and it has been suggested that there will be more. Professor Bell suggested that we ca cannie and be careful, even two years down the line when we have the powers. Do you have any feeling as to whether we could safely increase income tax by, say, 2 per cent and whether that would have much impact on behavioural response? Or are you not prepared to commit to a figure in that regard?

John Swinney: When we look at some of the analysis that has been undertaken by HMRC to inform this discussion—admittedly, this is about the SRIT and not about the powers recommended by the Smith commission—the estimated behavioural effects of a variation in the rate do not appear to me to be particularly significant. Even if there was a variation of 2 per cent, it does not look as though that would be particularly significant. However, that is about the SRIT. I think that both the committee and Professor Bell have explored different questions. Professor Bell explores different questions in his paper around some of the other opportunities and possibilities that exist through the wider powers from the Smith commission. That is why, before we come to exercise those powers, we have to do further work on the potential behavioural response to make sure that we come to properly informed conclusions.

John Mason: I totally agree that we should do that work before coming to conclusions, but the question has been raised with us about the point of our having all those powers—I realise that it is early days—if we are doing the same as the UK on LBTT, landfill tax and income tax.

John Swinney: I take a different view. On LBTT—

The Convener: The UK followed us.

John Swinney: We are now at the stage where the convener is feeding me lines. [*Laughter*.] That is very encouraging. However, the convener is absolutely correct.

We undertook a very significant reform of land and buildings transaction tax when it was implemented, and yes, the UK Government went for a similar system. I have taken steps in the supplement, for particular reasons, to try to avoid a situation whereby the market in Scotland was distorted by a change that took place south of the border. My rationale for the Scottish rate of income tax is not that I want to keep it the same as the rest of the UK. My rationale is that I am concerned that the exercise of the power in that respect would impose a burden on people who I do not think are in a strong position to pay it at this stage, and we do not have the fine-tuned measures to take account of that.

John Mason: On land and buildings transaction tax, there will now be 3 per cent extra for second homes. Can you tell me why there is a £40,000 minimum and why that figure was chosen, rather than nil or some other figure?

John Swinney: It was chosen on the basis that there are very few properties below £40,000 that are selling on the market. Secondly, I wanted it to apply essentially across all transactions, which is why the £40,000 level was, in my view, an appropriate one to set it at.

John Mason: Would nil not have worked just as well?

John Swinney: I suppose that there is an argument for that, which the committee could consider in relation to the legislation.

John Mason: You said that you are consulting as we go forward, and there will obviously be separate legislation. Are you consulting Westminster, which is obviously doing something similar? Will there be a joined-up approach, or will we do something entirely separate from what Westminster does?

John Swinney: We will take our own decisions. The Westminster Government has produced a consultation document that sets out some of its thinking, and we will continue to consider that and other issues, but we will take the relevant decisions here.

John Mason: On the more general tax, we have heard from various witnesses, quite a few of whom represent the property sector and people at the higher end of the property sector and who seemed to think that it was a bad thing that there might be fewer transactions over £1 million. My feeling is that, if there were no transactions over £1 million, that would be a good thing, because that would show that society was fairer and more equal, but I also accept that that means that you would get less tax, at least in the short term. In one sense, if the top end is being squeezed and the bottom end is being helped, that is good, and that is what the tax was meant to do, but how do you balance that up against actually seeing the revenues coming in?

John Swinney: That is where we have got to make a considered judgment in the round. I am pleased with the effect of land and buildings transaction tax on the lower end and middle part of the market. Encouraging trends have developed and have provided new opportunities for people in Scotland, which is helping the volume of transactions. Indeed, in the most recent quarter for which figures are available, July to September 2015, house sales reached the highest volume for any quarter since April to June 2008. There is movement in the housing market in Scotland at a level that we have not seen since the financial crash, so that is a helpful indicator.

In the first six months of LBTT, more than 5,700 additional house properties have been taken out of tax. All of that has taken place within a context in which the tax that I estimated would be raised, and which underpins the budget, is going to be raised. The housing market is stimulated, transactions have been taken out of tax that were not previously out of tax, so people have not had to pay that, which helps them into the market, and we have managed to raise the necessary tax to support public services and public finances. That is a pretty encouraging start to the exercise of the powers around land and buildings transaction tax.

John Mason: Are you not worried about the top end of the market?

John Swinney: I have already conceded that there was a very clear forestalling effect in the first few months of 2015-16 and in the last quarter of 2014-15. I cannot escape the conclusion that from January 2015 to August 2015 forestalling has had a significant on the higher end of the market. Now that that opportunity for forestalling has gone, over the period that lies ahead we will begin to see what the effect is on the market.

John Mason: If nothing else was changing, we would be able to look back and see that in itself, but we now have the 3 per cent supplement coming in, and presumably there will also be forestalling in relation to that. Will they start getting mixed up with each other?

John Swinney: I am not so worried about the forestalling on the LBTT supplement, because we will get the benefit of that.

John Mason: Yes, but will it perhaps be harder to measure?

John Swinney: I am just trying to recall the exact volume of such transactions. I do not have the precise number at the front of my mind, but I am pretty sure—and I can be corrected if I am wrong—that the transactions that will involve the 3 per cent LBTT supplement represent less than 10 per cent of the market. I cannot give you the exact number, but I can say that it is not fundamental, and also we will get the benefit of that.

John Mason: On that point, I thought that Westminster would refund us for the previous forestalling because it got the extra tax in 2014-15 that we have lost for 2015-16. When will a figure be agreed and when will Westminster pay it?

John Swinney: Those issues are tied up in the block grant adjustment discussions.

John Mason: Fair enough.

The Scottish Fiscal Commission mentioned that for landfill tax, the target equals the forecast. Our target is to get landfill waste down by a certain amount over a period and that is the same as the forecast. The SFC questions whether the target and the forecast should be different. Are you totally convinced that the target will be achieved?

John Swinney: Those are two different questions. It is right to link the revenue to be raised with the achievement of the targets, because if we did not do that, we could have an expectation of generating higher tax. Our objective for landfill tax is for the volume of landfill to come down. As the committee will see from the forward estimates, they are for landfill tax to go from £142 million—if the first two quarters are replicated for the remainder of the year—down to £94 million in 2020-21. If we did not have a relationship between the tax to be generated and the exercise of the landfill tax policy, we could end up expecting more tax than there could be any reasonable expectation of being generated.

John Mason: I was just thinking that, if we are expecting a reduction every year, that might vary by 1 or 2 per cent more or less.

John Swinney: That is undeniable. However, we now have better data and information on which to base our predictions; we can now see what we are generating in landfill tax much more clearly and we can also get more detailed information on the volume of landfill activity around Scotland. If we apply the right estimations of the pattern of landfill reduction, we should be able to get a better picture of what is involved.

John Mason: Thank you. You have already been asked about the block grant adjustment, but I want to clarify a point. You said that the 2016-17 adjustment is £600 billion—I think that I mean million.

John Swinney: I hope that it is £600 million not £600 billion.

John Mason: You said that the adjustment can be reviewed afterwards, but I take it that it will not be changed afterwards. However, if it turns out to be different, will it affect the next year's adjustment? They will not go back and change the adjustment for 2016-17, will they?

12:00

John Swinney: Well, we have agreed a provisional number to enable me to settle the budget and I have to accept that there is the opportunity for a provisional number to be reviewed. That would happen with the benefit of outturn data for 2014-15, 2015-16 and 2016-17. Therefore, the number could be reviewed if there were a better figure.

John Mason: If we did better for land and buildings transaction tax in 2016-17 than we are budgeting for, could that be taken back off us?

John Swinney: There is an interaction between the tax raised and the level of the block grant adjustment. Terminology such as

"could ... be taken back off us"

is difficult because we have a provisional block grant adjustment number and a provisional tax expectation number and we have agreed that those can be reconciled with outturn data once we see the pattern of the performance on tax. Therefore, there is the potential for those numbers to be revisited. That would be informed by the outcome of the fiscal framework negotiations.

John Mason: Yes, but our long-term hope is that there would be a fixed agreement and it would not be changed retrospectively.

John Swinney: Those comments apply only to the £600 million figure for 2016-17—it is just for that one year. My hope is that we will have a fiscal framework that operates mechanically.

John Mason: We had a good session last week with the Scottish Fiscal Commission, which has been quite challenging to the Government in some of the discussions that have gone on over the year. For example, one of the things that the commission said was:

"Progress overall in developing the forecasting methodologies has been slower than the Commission had hoped."

Leaving aside the substance of that, I think that it is good that the commission has been asking such questions and challenging the Government. If it was doing the forecasts, who would challenge it in that way?

John Swinney: Anyone who reads the material that the Fiscal Commission has published and looks at the interaction cannot come to any conclusion other than that it has been a vigorous process of challenge. Admittedly, it has been shouldered more by my officials than by me, but it has been a challenge. The Fiscal Commission has provided a sustained challenge. That is exactly what we set it up to do and it has served Scotland well in exercising that degree of challenge. I welcome it.

Mr Mason raises an issue about who, if the Fiscal Commission were producing the forecasts, would challenge it and who could do so as effectively as it has challenged the Government. Lady Rice and Professor Hughes Hallett made that comment to the committee, and that is a real issue.

Jackie Baillie: Out of curiosity, I will start off where John Mason left off on the Scottish rate of income tax. Cabinet secretary, you said that you did not have the range of finessed powers to compensate people. You gave the example of the council tax reduction scheme, but we could have landed on the bedroom tax. Might local government not have a set of powers that you could have sought to use?

John Swinney: For the sums of income involved, it requires a fine level of accuracy and precision to make it possible and practical to try directly to compensate people. There are eligibility criteria that drive the two schemes that Jackie Baillie cites. On the council tax reduction scheme, we have, in essence, had to mirror the council tax benefit arrangements in an almost flip-side fashion. That has been a helpful navigation through the issue, to make sure that, broadly, we got council tax reduction to the people who required it. We would have found that more difficult using the income measure, and there would also need to be a statutory basis for paying it.

The statutory basis exists for discretionary housing payments for bedroom tax, and it exists for council tax reduction, because we have legislative competence over the council tax. I would be interested to hear how we might arrange income compensation, outwith a provision such as the Scottish welfare fund, but it strikes me as being quite difficult for us to find a practical way to do that within legislative competence.

Jackie Baillie: I would interpret that as meaning not so much that there is no power but that there is not a sufficiently finessed power. Would that be fair?

John Swinney: I am not sure that there is much difference between the two. The point that I am making is that, to address the challenge that John Mason has set, a proposition needs to be put forward that is very individually focused and targeted. I do not think that the powers exist that would enable us to do that—at this stage.

Jackie Baillie: I turn to LBTT, with a focus on the residential element, because that is where there is concern. The non-residential element seems to be performing reasonably well, indeed better than forecast.

I am pleased that the OBR has revised its forestalling figures; that will benefit the Scottish Government financially. There is, nevertheless, a shortfall forecast to the end of the year. I have sat with you here before when you have, with some justification, accused the OBR of being incredibly optimistic in some of its forecasting. I now sit here and look at page 16 of the Scottish Parliament information centre’s briefing—you may have had an opportunity to look at it; I recommend it to you—which shows a complete reversal of that situation. The OBR is much less optimistic than the Scottish Government. For 2016-17, the OBR estimates that there will be £40 million less revenue from residential transactions. In that table, which is figure 7 on page 16 of the briefing, the Scottish Government figures are helpfully in blue while the OBR figures are in pink. The difference in the figures, by the time you get to 2020-21, is more than £70 million.

Let me put that in the context of your modelling. In your paper on the forecasting methodology, in table 7 on page 9, your forecast of the annual growth in volume of residential transactions, although positive overall, is declining. It goes from 5 per cent this year down to 1 per cent in 2020-21. I am trying to understand. Has the OBR suddenly become much more pessimistic, and on what basis? Why has the Scottish Government, given what we know about likely shortfalls this year, become so optimistic in the face of the evidence that it has presented about the declining volume of sales?

John Swinney: The first thing that I should say is that I do not expect there to be any shortfall in revenue this year over the devolved taxes that underpin the budget of the Scottish Government. Our budget requires £498 million in revenue to be raised and I am confident that that will be exceeded. I foresee no shortfall in the devolved tax revenues for 2015-16.

Jackie Baillie: Is that overall?

John Swinney: Yes.

Jackie Baillie: My question was about residential LBTT.

John Swinney: Yes. For the sake of clarity I say that I do not envisage any shortfall in 2015-16.

We are currently about £31 million adrift on residential LBTT. The estimate of forestalling has now been revised up by the OBR to between £20 million and £40 million—a mid-range of £30 million. What that says to me is that the estimates that we have put in place, while taking into account the issue of forestalling, are in the right scope.

I read with interest the contribution that Robert Chote made to the committee last week. It was an interesting discussion. I should point out that the estimate for 2015-16 from the OBR at the autumn budget revision was substantially revised down from the position that it took in July, and much more in line with the forecast that we have been making, which has been validated as reasonable by the Scottish Fiscal Commission. I think that all of the changes that we have seen happening are welcome.

Looking at the forward revenue forecasts over the next five years, I note that Mr Chote ascribed the difference to the Scottish Government

“assuming slightly more rapid increases in house prices over the period”,

and to a higher assessment of the increase in the number of transactions over the period. The latter point is essentially us assuming that we will return to the average number of house transactions in Scotland that we have seen over some years.

In characterising the difference between the OBR forecasts and the Scottish Government's forecasts for the next five years, Mr Chote said:

> "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."—[*Official Report, Finance Committee*, 6 January 2016; c 10-11.]

That puts the matter in its proper context.

This is the first time that we have done a forward forecast for five years, but the OBR has done—I think—one before, and the most recent one was a substantial revision downwards of the figures that it had previously, which is much more in line with our expectations.

Jackie Baillie: I observe that Mr Chote was diplomatic and acknowledged that different forecasting models are deployed. It will be interesting for us, as anoraks, to consider which is the more accurate as we move forward. I assume that you and the Government will want to get your estimates of yield as near perfect as possible. You said that you think—

John Swinney: May I make a comment? I accept that. It is incredibly difficult to be absolutely precise about all the figures in our predictions, particularly when we start to look five years hence. However, the evidence that I would marshal on our plans for 2015-16 and the way I would summarise things is that our residential forecasts have been undermined by forestalling and our non-residential estimates and landfill tax expectations have been exceeded by performance. In the round, we are going to generate the amount of revenue that is required to support public services in Scotland. For our first year of estimating and predicting tax, I think that that is quite an encouraging position to be in.

Jackie Baillie: My questions related to residential transactions because that is where there is a differential that is worth exploring. I think that you said that the estimate is based on returning to an average volume of house sales. Is that correct? My concern about the data is that, under your forecasting methodology, the forecast volume of sales is set to decline—while still remaining positive, which is good news—from 5.43 per cent this year to 1.25 per cent. That must have an impact on the forecast revenue that the Government is assuming.

John Swinney: That is about a growth rate. I assume that you have seen our forecasting methodology paper, which shows how the Government estimates that as a result of the growth that takes place over the next number of years we will end up in a position in which we have returned to average annual growth in volume of residential transactions. As we can see from the table on page 9 of the paper, you are absolutely correct to say that the growth rate in transactions is slowing. However, that growth rate will get us to the average volume of residential transactions.

12:15

Jackie Baillie: What is the average?

John Swinney: It is 6 per cent.

Jackie Baillie: And will we get to that? That is not evident from the table.

John Swinney: It is shown in the graph in figure 1 on page 9 of "Scottish Budget Draft Budget 2016-17: Devolved Taxes—Forecasting Methodology", and the detail that underpins that is in table 7. The information is taken from Registers of Scotland and the register of sasines.

Jackie Baillie: I just think that it is quite optimistic, given where we are. However, your response is interesting—

John Swinney: I will go back to the point that I discussed with Mr Mason. The Scottish Fiscal Commission has put the Government through the wringer—if I may talk in a language that we all understand—and has judged our forecasts to be reasonable.

Jackie Baillie: With all due respect, it also judged that two years running it had not had an adequate response to the additional request to model the behavioural response to LBTT. In relation to the action plan that was presented late in the day, I do not want to put words in the SFC's mouth, but I think that its annoyance that so little progress had been made on such an important item was evident from our dialogue with it last week.

John Swinney: The Government's modelling paper contains extensive detail on behavioural analysis. I am not for a moment suggesting that this is the end of the story. I accept that we must continue to refine our approach to behavioural analysis and I do not want in any way to suggest that we are not doing so. The commission is quite right to tell us that we must do more and I accept that. We will do more.

Jackie Baillie: There was a sense of urgency about that, rather than it being something for the long term. If you are reflecting that urgency, that is very welcome.

Let us move on to borrowing. In the budget you committed to using the limit of your borrowing powers, which is £316 million in 2016-17. I understand that the figure for this year was about £320 million, give or take—

John Swinney: It is £304 million.

Jackie Baillie: Thank you, cabinet secretary. None of that has yet been drawn down and I am not sure whether you have established the mechanism by which you would do that. Is the issue caught up in the fiscal framework discussions? Do you intend to draw the money down? If so, when, and what are you likely to spend it on?

John Swinney: I will take your questions in reverse order. We will spend it on our capital programme—in essence, the borrowing facility is there to fund our capital programme.

The amount of borrowing that we draw down will depend on the amount of funds that we require to support capital projects within a year, so you will understand that I will not borrow any money that I do not require to use. If I had capital projects that were not required to be paid this year, there would be no sense in my borrowing the money. There is no sense in my borrowing £304 million if I do not need to spend £304 million, for example because the wet weather has slowed up a project and not much money is going out of the door on that particular project—or whatever the reason happens to be.

The issues are not tied up in the fiscal framework. The arrangements are in place, and we will borrow at the cheapest rate; whatever route we take will be the cheapest, in terms of repayments. We will borrow the amount of money that we require to support our plans between now and the end of the financial year, and I will update Parliament about the steps that we take in that respect.

Jackie Baillie: At what stage will you arrive at a conclusion, given that we are well into the budget process?

John Swinney: That is an active issue on my agenda, and I am looking at it on an almost daily basis.

Jackie Baillie: So the Government's response is, "Soon."

John Swinney: Oh, no. I know what the Government response "soon" means, and it will be much earlier than that.

Jackie Baillie: Oh, that is even better. Soonest. There we go.

I would like to explore a borrowing power that the Government currently has for revenue. I listened carefully to what you said, and that power gives you the ability to borrow revenue up to £200 million in a given year if your receipts are less than were anticipated. You are confident that, in all areas, your receipts will exceed expectations overall.

John Swinney: Yes, I am.

Jackie Baillie: You have no concerns about non-domestic rates or, indeed, the LBTT residential element.

John Swinney: I can use that resource-borrowing facility only for devolved taxes; I cannot use it for non-domestic rates.

Jackie Baillie: That is fine. Let us move on to non-domestic rates. There is a forecast fall in revenue of 2.8 per cent in real terms. That is quite substantial and I think that it is the first time that a fall has been estimated for 2016-17. Is that the influence of the Fiscal Commission saying that your buoyancy estimates were too optimistic? Or is there something else going on that has led to that?

John Swinney: Two things are affecting the non-domestic rates pool. First, there is the effect of inflation, which is much lower than was predicted when we made our estimates of non-domestic rates. For example, the inflation forecast for 2015 reduced from 3.3 to 2.1 per cent, which has a substantial effect on the amount of non-domestic rates that we could expect to come forward. Secondly, the buoyancy estimate for 2014-15—which, you will recall, we reduced after the Fiscal Commission suggested it was optimistic—was 1.55 per cent but it actually translated to 0.82 per cent, which has an effect on our estimates. I would characterise the fall as being down to the effect of those factors rather than the estimation.

Jackie Baillie: That is helpful to know. You have set a large business supplement at 2.6p, which, I understand, is double the comparable rate in the UK for similar-sized properties. You have kept quite a close correlation between the UK and Scotland on income tax, LBTT and landfill tax. Why have you approached non-domestic rates differently? I assume that you are collecting, in totality, the same amount but you are placing the burden in different places. Is that a fair assumption?

John Swinney: It is roughly the same amount, yes. In some cases, there are similarities between the approach that we have taken here and the approach that is being taken in the rest of the United Kingdom, but in others we have taken a dramatically different approach. For example, we have taken a dramatically different approach on the small business support scheme, as our scheme has been significantly more generous than the scheme in the rest of the United Kingdom. We are at the more generous end of the spectrum in that respect.

I faced difficult choices and came to the conclusion that, on the specific issue that you raise, I would have to take steps to strengthen the volume of revenue raised by non-domestic rates. I therefore decided to apply a higher business supplement for large business properties. That translates to a total increase of 3.4 per cent in the rates bill for a company that pays the large business supplement combined with its core business rate compared to an annual increase in 2015-16 of 2.3 per cent.

If we look back over the last few years, in 2011-12 the increase in the rates bill for a company that was paying the large business supplement was 4.6 per cent, and in 2012-13 it was 5.8 per cent. Set within that context—particularly when we have had pretty low levels of business rates increase because inflation has been reducing those increases—I think that 3.4 per cent is a not unreasonable charge for us to make.

Jackie Baillie: I think that businesses might take a slightly different view. I have had a letter from Asda that states that it would pay 2.6 per cent higher rates in Scotland than in the rest of the UK. Businesses reference the commitment that you and the First Minister gave to ensure that the rates regime is the same north and south of the border. You would not want to create any disincentives for business, so you would want rates to be kept in line with the rest of the UK. There are genuine concerns from businesses about the investment decisions that they will make on the back of that.

John Swinney: I understand those concerns and I do not in any way dismiss them. I would just say that our commitment has never been to have the same business rates regime as England, because, as I have explained already in relation to the small business bonus scheme, we have had a significantly more generous scheme in place. Our commitment has been to maintain the uniform business rate, which we have maintained at 48.4p. However, I took a decision that it was possible to increase the large business supplement to strengthen the non-domestic rates pool.

Mark McDonald: A lot of ground has been covered already, so I have only a couple of questions.

Cabinet secretary, you mentioned the impact of forestalling and said that that is forming part the discussions that are taking place with Treasury ministers on block grant adjustments.

I wonder whether the Treasury has given any indication of its numbers related to the impact of forestalling, particularly in its March figures. We have had figures put before us that show a quite substantial forestalling on £1 million-plus properties in the March period, which I imagine led to quite a boon for the Treasury in that period as well. Has there been any indication from the Treasury on that?

John Swinney: Not from the Treasury. Obviously the OBR forecast has increased, which I think is an independent validation of all those questions.

Let me think. The data on the number of transactions must be—will be—available to us; I am just looking at my papers. In Registers of Scotland's statistical release for July to September, there is such data, but I do not know whether it goes down to the degree of detail on price bracket that you are asking about. I do not think it does in this publication, but I am pretty sure that Registers of Scotland—

Mark McDonald: If I can be helpful, the numbers that were put before us were from a Your Move/Acadata examination of house transactions. They indicated that 90 £1 million-plus sales took place in March and none in April.

John Swinney: As I said, I accept that forestalling had an impact, where transactions took place between January and March, and that will have had an effect on the market. I have made no attempt to avoid that point.

Mark McDonald: No, indeed. I was merely asking whether the Treasury had given you a look at what data it had on the impact on stamp duty land tax during that period.

John Swinney: No.

Mark McDonald: That is helpful in that respect.

On the SRIT and the on-going budget discussions, I know that you have always said at budget time that if other parties in the Parliament have alternative approaches or would wish to see something different being done, your door is open to them. Leaving aside any comments from the deputy convener, have you received any other opinions or views in relation to what you should be doing on the SRIT at this stage?

John Swinney: It is early days. [*Laughter*.]

12:30

Mark McDonald: Finally, to wrap up the issue of forestalling and behavioural response and so on, there is a contrast between the approach taken at Westminster, where the chancellor stands at the dispatch box and says, "I am announcing a change and it is effective as of midnight," which is a bid to prevent a forestalling effect, and the approach taken by the Scottish Parliament that is a legacy of the parliamentary approach to budget scrutiny. I know that you are very keen to respect the views and wishes of Parliament on that. Given that, as we get more powers over areas of taxation the likelihood of behavioural response to pre-announced changes increases, do you have a view on whether there is a more helpful approach that could be taken?

John Swinney: It raises some issues for Parliament to consider about how we organise ourselves. I am happy to engage in discussion with the committee about those points. The ability of the chancellor to change stamp duty rates that night created a difficulty for us and we can see the effect of that, which is approaching £30 million-worth of a problem for us. It is a tangible issue.

What I am doing with the 3 per cent LBTT supplement requires primary legislation and we are going to have to move at some pace, as the committee may have noticed—he says, delicately. The advantage that we have is that if there is a forestalling issue, we are not at risk, rather we get the benefit, unless, that is, people in England decide to buy holiday homes or buy-to-let properties in Scotland to avoid the George Osborne 3 per cent proposition in the window between January and March. That might happen for properties that would attract an LBTT charge here, but I do not think that it will be on the scale of £30 million.

There is an issue to be explored about our process. We might need a slightly more nimble process to address such questions. That is a discussion that I am happy to engage in with the committee.

Mark McDonald: The chancellor is not necessarily restricted in when he brings in such changes; as we saw, he did not have to announce the stamp duty change at a specific point in the calendar year. Again, is that something that you are reflecting on or should Parliament be reflecting on the flexibilities within the parliamentary structures to allow for such an approach in future, should the Scottish Government choose to make changes?

John Swinney: Notwithstanding the requirement for us in certain circumstances to respond promptly and swiftly, I take the view in general that it is a good thing to do all such things as part of a budget process and to set out—as I did in December, albeit that it was late in the year—the whole picture of tax, revenue and expenditure all in one go to allow Parliament to consider the issues.

Gavin Brown: In answer to Jackie Baillie, you said that you think that the devolved taxes for 2015-16 will come in ahead of projections. If that happens, was the block grant adjustment for 2015-16 "without prejudice", or could it spark a review? Was it slightly different from 2016-17, in that it was absolutely fixed for the year?

John Swinney: My recollection is that it was absolutely fixed.

Gavin Brown: So there is no risk. However, you said that for 2016-17, the adjustment is, to use your term, "without prejudice".

John Swinney: That is perhaps to do with the fact that we have had to have a second year of a one-off block grant adjustment. I do not think that anybody wanted that, but it is happening because we do not have agreement on the fiscal framework. The budgets are in two different categories. I am not complaining about any part of it—it is where we are.

Gavin Brown: The OBR projection is something like £627 million and your projection is £671 million. The £600 million is a good bit below both those estimates, so are we not almost certain to have some kind of adjustment later?

John Swinney: We'll see. [*Laughter*.] As a father of numerous children, Mr Brown will know what "We'll see" means.

Gavin Brown: We could spend the rest of the day discussing that. I suspect that we will not get much more clarity, so I will move on.

On income tax, you set the 10p rate for 2016-17. My recollection could be wrong—I am going by the statement that you gave to Parliament, which I have not reread in advance of this meeting—but I am 50 per cent sure that you said that the Government will set out its medium-term intentions in the early part of the year. Obviously, there is an election coming up in May, so things will depend on who is running the country after that. Do you intend to set out over the next month or two the Government's medium-term intentions for income tax?

John Swinney: I would like to be able to quote exactly what I said, but I will struggle to find that part of my statement without keeping the committee waiting. Essentially, what I said was that, subject to securing agreement on a fiscal framework, I will set out our medium-term approach to tax.

I can now confirm that I said:

> "I hope that, from 2017-18, the Parliament will have more flexibility in setting income tax rates. However, that will depend on reaching agreement on a new fiscal framework and final passage of the Scotland Bill. I confirm that, subject to achieving those outcomes, the Government will set out its longer-term intentions with regard to income tax ahead of the dissolution of Parliament at the end of March."—[*Official Report*, 16 December 2015; c 33.]

I was making the simple point that we will not be able to set out our position if we do not have a fiscal framework because we will not have the Scotland Act. However, if the fiscal framework is agreed by 12 February, which is before dissolution, I will set out my position to Parliament.

Gavin Brown: We have talked a bit about non-domestic rates. I am looking at page 95 of the budget. From 2015-16 to 2016-17, non-domestic rates appear to go down, not just in real terms but in cash terms, by about £30 million. I assume that included in the figure for 2016-17 is the £130 million or so that you anticipate will be collected.

John Swinney: Yes.

Gavin Brown: Like for like, non-domestic rates are potentially down by £160 million. Even with an increase in the poundage of 0.8 per cent, taking you to 48.4p, and with the increase in the large business supplement up to 2.6p, we are still down in cash terms by £30 million. Obviously, growth for the economy as a whole for that year is projected to increase. I am at a loss to understand why we are going down in cash terms when we have increased taxes and overall economic growth is projected to be in the region of 2 per cent.

John Swinney: I am exploring the very same questions. I would add into that the pattern of non-residential LBTT transactions, which are very encouraging. I am determined to understand the relationships between all those things. According to figures that have been announced this morning, gross domestic product growth for this quarter is 0.1 per cent. We are at 1.7 per cent annualised growth, which is reasonably healthy. By comparison, the UK is at 2.1 per cent. There is growth in the economy.

Non-residential transactions are performing well—much better than we anticipated. What I do not know is whether they are performing better because our estimate was not good or was not as effectively informed by data as it might have been, or whether it is because the economy is doing well. According to analysis, the availability of property is looking tight again in some parts of the country. A variety of factors make the non-domestic rates position look a bit out of kilter. I am exploring that issue—it is a reasonable issue for Mr Brown to raise.

Gavin Brown: We are most of the way through the current financial year. Are we on track with regard to the 2015-16 figure for non-domestic rates, or was the position slightly optimistic, with the result that there is an adjustment for 2016-17?

John Swinney: There will be some effect in 2015-16 because of the reduction in inflation. Such factors will begin to play in, as will some of the effects of buoyancy; they will affect the non-domestic rates pool

Gavin Brown: So, as far as you aware, are we slightly behind schedule for 2015-16, or is it too difficult to say?

John Swinney: It is difficult to be precise about that. We will get a better idea as the year goes on.

Gavin Brown: You have been asked a couple of questions on the large business supplement. Has a business and regulatory impact assessment been carried out for that? If not, will there be one?

John Swinney: We are in consultation on that. That is the context in which we will consider issues that are relevant to a business and regulatory impact assessment.

Gavin Brown: I want to focus on the residential aspect of the land and buildings transaction tax. You have made comments about the behavioural impact, and there appears to be a bit of a disagreement. Earlier, you told the convener that you believe that it is, as a general proposition, important to consider the behavioural impact of tax, and that that is something that you will work on year by year. You appear to have put those words into practice in relation to the LBTT supplementary charge, in trying to work out its behavioural impact.

However, I want to ask you about something that the Scottish Fiscal Commission said in its report—in paragraph 8.3 on page 37—and reiterated in the committee last week. Last year, the Scottish Fiscal Commission recommended that the behavioural response be considered in relation to LBTT. Now, it says:

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

Over the piece, the commission has expressed its view pretty strongly. What will the commission have to do before you consider the behavioural response to LBTT?

John Swinney: That work is being undertaken now, in the light of the commission's recommendations, and it will have an effect on our projections—all of which will have to be tested by the commission.

Gavin Brown: Instead of just doing single-year projections, you have helpfully set out your projections over the whole five-year period. When we get to £545 million-worth of residential LBTT, your assumption—according to the Scottish Fiscal Commission—is that £188 million of that sum will come from fiscal drag. The commission raises some questions about how viable that is. Is it the Government's intention that there will—the position will depend on the outcome of the election—be no changes at all to the threshold over that five-year period?

12:45

John Swinney: In the forecasts that we have published, there are no changes to the assumptions. There is a rolling forward of the existing policy precision on LBTT. Of course, I must reserve the Government's right—if the Government is fortunate enough to be re-elected—to change the provisions if it decides to do so. I do not want the committee to read the estimates as definitive predictions; they are predictions based on application of the current policy framework and the variables that will get us to that point in 2020, for example.

I discussed with Jackie Baillie some of the issues around the number of transactions and assumptions about price, and Robert Chote discussed some of those issues with the committee. We have to be careful about the five-year forecasts: they are just a setting out of what would happen if we did not change anything, but we may well change things, and that will be for the Government to decide in due course. We are setting out a proposition for 2016-17 that underpins a proportion of the budget. That is critical.

Jean Urquhart: As I am sure all the committee members did, I received a letter from Asda about the large business supplement. I observe that, before the Scottish Parliament existed, the differential between rateable value in Scotland and England was dramatic, and not in Scotland's favour. It was only when you, I think, adjusted the poundage that our rates started to become anywhere close to being equal with those in England. It is worth noting that Asda and other such companies are only just beginning to pay non-domestic rates that are comparable with those in England.

John Swinney: In the interests of fairness and accuracy, I point out that a previous Government—the then Scottish Executive—took such steps in its latter days. I think that those probably happened in 2005-06 or 2006-07.

Graham Owenson (Scottish Government): I think that it might have been 2006-07.

John Swinney: Jean Urquhart is right that, for many years, the poundage rate in Scotland was higher than that in England. The rates were equalised in, I think, 2006-07 and the Government has sustained that since then. I point that out just to be fair.

Jean Urquhart: I am happy to be fair, cabinet secretary.

I will ask about the timelines. You said at the beginning of the meeting that the Scottish Parliament must be satisfied with the fiscal framework and that there would be opportunity for scrutiny. The parliamentary session will cease on 20-something March and you hope to reach agreement on something that you can present to the Parliament on 12 February, so do you hope that scrutiny will be completed and that you will invite the Scottish Parliament to approve the agreement before the Scottish election?

John Swinney: I have made it clear to Parliament and the United Kingdom Government that we will not put a legislative consent motion on the Scotland Bill to Parliament unless we have a fiscal framework that we can recommend to it. Therefore, the timetable dictates that we must have agreement for that in place in time for us to lodge a legislative consent motion by 12 February.

If we get to that point, I will recommend to Parliament a fiscal framework that I have negotiated. I go into that negotiation in good faith to secure an agreement that will implement what was required of us by the Smith commission. There is a possibility that I will not be able to get an agreement that I am satisfied is consistent with the Smith commission's proposals. If so, I will not come to Parliament with such a recommendation. I hope not to be in that position, because I want us to be able to exercise the powers that we will have under the Smith commission's proposals.

That is how the sequence of events works. I accept that the committee is not able to see an early, mid or late draft of the agreement for the reason that there is no such draft because we do not have an agreement yet. That is being worked through. I will come to Parliament with a legislative consent motion only if I am satisfied with the detail of the fiscal framework that is before us.

Jean Urquhart: I might be ignorant of the procedures, but will there be any public consultation on the agreement?

John Swinney: No.

Jean Urquhart: What scrutiny opportunities will there be? As you know, a number of economists are anxious about that.

John Swinney: The issues about the fiscal framework have been pretty well aired in the wider media. Indeed, the committee has taken evidence from a range of different experts on the question. The issues are out in the open.

I appreciate that it is not ideal, but throughout the process I have taken part in parliamentary debates and the committee's inquiries—I have appeared on a number of occasions to give evidence—and I have tried to inform the discussion as much as I can about the issues that are at stake. However, I cannot tell the committee the detail of the agreement. That is not because I am keeping it to myself but because it is not agreed. Nonetheless, I am clear in my mind what has to be in that agreement because the Smith commission set it out. If that is not what is in the agreement, the legislative consent motion will not come to Parliament.

The Convener: That appears to have concluded questions from the committee. I have one or two questions to follow up. On non-domestic rates, what is the buoyancy rate for 2016-17 and how does it compare with 2015-16?

John Swinney: The buoyancy rate for 2016-17 is 0.97 per cent and for 2015-16 it is 1.25 per cent.

The Convener: I have a follow-up to a question that Mark McDonald asked. You talked about not having discussions with the Treasury about forestalling. Was that not part of the discussions about the block grant adjustment?

John Swinney: No, Mr McDonald asked me whether I had had discussions about the number of £1 million properties. We and the Treasury have talked about forestalling.

The Convener: I apologise.

Mark McDonald: To clarify, convener, my question was about whether the Treasury had given any indication of the impact that forestalling had had on its revenues. The cabinet secretary indicated that that was not the case.

The Convener: I have a question about the SRIT and whether or not it is regressive. [*Laughter*.] The Scottish Trades Union Congress has said that the SRIT is regressive. One of the reasons why it said that is that if the basic rate of tax goes up from 20p to 22p, that is a marginal rate of 10 per cent whereas, for higher taxpayers, an increase from 45p to 47p is a marginal rate of 4.4 per cent.

Jackie Baillie: Is that a question?

The Convener: The question is this: is that the case?

John Swinney: Those factors are absolutely correct, convener, but I cannot deny that the Scottish rate of income tax as it stands is progressive. We have to be careful that, in the decisions that we take, we maintain that progressivity.

The Convener: Do you wish to add anything before we wind up?

John Swinney: I wish only to say that I look forward to meeting the committee in my constituency on Monday. I am profoundly grateful to the committee for enabling me to welcome it to Pitlochry.

The Convener: As you know, it is a key marginal seat. We are trying to do all that we can to assist you with the election, which is only a few months away. [*Laughter*.]

I thank everyone for their questions and contributions.

Meeting closed at 12:54.

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