OFFICIAL REPORT
AITHISG OIFIGEIL

Finance Committee

Wednesday 21 September 2016

Session 5

The Scottish Parliament
Pàrlamaid na h-Alba

Wednesday 21 September 2016

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FINANCE COMMITTEE
5th Meeting 2016, Session 5

CONVENER

*Bruce Crawford (Stirling) (SNP)

DEPUTY CONVENER

*Alex Johnstone (North East Scotland) (Con)

COMMITTEE MEMBERS

*Neil Bibby (West Scotland) (Lab)
*Willie Coffey (Kilmarnock and Irvine Valley) (SNP)
*Ash Denham (Edinburgh Eastern) (SNP)
*Murdo Fraser (Mid Scotland and Fife) (Con)
*Patrick Harvie (Glasgow) (Green)
*James Kelly (Glasgow) (Lab)
*Ivan McKee (Glasgow Provan) (SNP)
*Maree Todd (Highlands and Islands) (SNP)
*Adam Tomkins (Glasgow) (Con)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Professor Graeme Roy (Fraser of Allander Institute)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Finance Committee

Wednesday 21 September 2016

[The Convener opened the meeting at 09:30]

Decision on Taking Business in Private

The Convener (Bruce Crawford): Good morning, colleagues, and welcome to the fifth meeting of the Finance Committee in the fifth session of the Scottish Parliament. As usual, I remind members to switch off their mobile phones or at least put them into a mode that will not interfere with today's business.

Agenda item 1 is to decide whether to take item 3 in private. Do members agree to do so?

Members *indicated agreement.*

"Scotland's Budget—2016"

09:30

The Convener: Agenda item 2 is an evidence-taking session with Professor Graeme Roy on the Fraser of Allander institute's report "Scotland's Budget—2016". Members have received copies of the report, which considers the outlook for the Scottish economy. Having read it from cover to cover, I see that the Scottish Government and the Scottish Parliament have a significant challenge ahead of them.

I welcome Professor Graeme Roy to our meeting. Do you want to make an opening statement?

Professor Graeme Roy (Fraser of Allander Institute): Yes, I can do.

Thanks very much for the invitation to come to the meeting to talk about the report that we published last week. I will give members some context about what we are doing in the Fraser of Allander institute, as that might be quite useful for their thinking.

Over the summer, we put a lot of investment into expanding our capacity in fiscal and economic analysis, and we have been able to get some really talented young people in. It is really exciting and encouraging for Scotland that we can now have much better analysis of issues such as the economic and fiscal challenges for Scotland.

This report is our first foray into that landscape. In it, we have essentially looked at the type of scenarios that the Scottish budget might face over the next session, given what we currently know about the previous Chancellor of the Exchequer's plans for departmental spending, what we think might happen in the autumn statement if the new chancellor chooses to "reset fiscal policy" and what that might look like. We know that, as of next year in particular, substantial new tax powers will start to kick in and the outlook for Scotland's economy and those revenues will start to have an increasing impact on the Scottish budget. Essentially, we have tried to pull all of that together to provide a number of scenarios, a flavour of what the Scottish budget might look like up until the end of the session and the challenges and opportunities that will come in.

In the second part of the report, we look at the big commitments that the Scottish Government has already committed itself to, trace them through and look at how much of the Scottish budget will be committed to that over the next few years. Essentially, we ask what that means for everything else and what the opportunities, challenges and risks are.

At the end of the report, we indulge ourselves in talking about what we think should be the key priorities and issues on which the debate should be focused in what we believe will be quite a challenging environment over the next few years, and those issues relate to transparency, scrutiny and the focus on outcomes. We set out what we think should be the key themes for discussion over the next few months as the Government and Parliament look to set the budget.

The Convener: Thank you, professor.

Your report outlines a number of scenarios for Scotland's budget over the coming years, many of which are challenging, to say the least. I have a couple of questions, the first of which concerns the short term and the second the longer-term issues to do with structural challenges.

First, with regard to 2017-18, I would be grateful if you could lay out for us the potential Scottish budget reduction scenarios that are likely to result from the chancellor's autumn statement and give us your views on how challenging those reductions will be for the Scottish Government and the Scottish Parliament.

Professor Roy: Using 2016-17 as the baseline and then looking to 2017-18, I think that, prior to Brexit and the talk about fiscal reset, it was forecast that the resource departmental expenditure limit in the Scottish budget would fall around £100 million between those two years. It is quite a useful starting point to remember that the budget was going to fall between this year and next year anyway.

What could fiscal reset look like? One scenario is that the chancellor decides to stimulate public spending and boost departmental public expenditure. As an approximation or rough outline, we think that that could add an extra £100 million to the Scottish budget next year. However, on balance, our feeling is that, if the chancellor is going to stimulate fiscal policy in the autumn statement, that is more likely to focus on things such as tax cuts or capital investment, as they are more likely to have an immediate positive impact on the economy. If you are worried about economic uncertainty, boosting consumer spending and household incomes typically tends to have a more immediate impact than increasing departmental expenditure. That is one scenario.

The scenario that is probably the bleakest outlook for the Scottish budget is the situation where, if the chancellor believes that he is going to miss his fiscal targets or at least has the intention to get the deficit down over the next few years, he might decide to take further money out of departmental spending in the short term. We have a scenario in which we assume that he wants to take an extra £9 billion over the next four years and we consider what that would look like for the Scottish budget. It would mean that, next year, there would be an additional £200 million reduction in Scotland's budget, on top of the £100 million reduction that we already have. We are talking about an additional reduction of £200 million to £300 million next year.

The Convener: If, as your scenarios suggest, the figure is out at that £300 million margin, how challenging will that be for the Scottish Government?

Professor Roy: One view of that would be to look at the budget in its entirety and say that, given the £26 billion-worth of expenditure, an amount coming out of the magnitude of £200 million or £300 million would not be that significant. The alternative view is to look at the discretionary element in the budget. We know that a large proportion of the budget is already largely determined by wages and spending commitments, so a cut of £200 million or £300 million between this year and the next is significant and would be a challenge.

The Convener: What measures might the Scottish Government be able to take to deal with that challenge?

Professor Roy: The Government could do a number of things in response. There is a question—the answer to which will probably be revealed at the autumn statement—about whether the changes are a temporary reaction and whether the chancellor will change the profile of public spending so that it increases towards the end of the Parliament. Depending on what happens in the autumn statement, there might be opportunities for the Government to reprofile spending. Obviously, tough choices will have to be made in the prioritisation of expenditure programmes. The Scottish Government might choose to utilise its new tax powers to try to make up some of the difference, or it might choose to prioritise expenditure in other areas. It would be a challenging situation.

The Convener: You have explored well the general conditions for the next financial year.

Neil Bibby (West Scotland) (Lab): Professor Roy, you talked about prioritisation of spending. As mentioned in your report, the Scottish Government has commitments to increase health spending, maintain police expenditure and expand childcare. It also has a commitment to other policies such as free tuition. As things stand, can those be delivered without cuts in other areas of spending? What is the largest budget outside those priority areas where we could see cuts?

Professor Roy: With a tight fiscal settlement—which, as we have shown in the report, is likely to be the case—it necessarily follows that choosing to prioritise and increase expenditure in some areas there will have consequences, as it means that other areas in the budget have to take up the slack and have to be cut to compensate. Therefore, even if the budget is flat in real terms over the next few years, if the Government chooses to prioritise spending and increase it in some areas, that necessarily means that other areas have to fall back. To be clear about this, and as we say in our report, I think that if you are going to criticise or have concerns about cuts in other areas, it necessarily follows that you cannot make those commitments to increase.

Essentially, it is a zero-sum game. If you are going to add with one hand, you have to take away with the other. Health, childcare and the police service are quite big commitments so, in the report, we look at what is left—in other words, the unprotected areas, the largest of which by far is the local government settlement at around £6.8 billion. As a rough approximation, you are looking at a resource budget of approximately £26 billion, £14 billion of which is largely protected. Of the £8 billion or so that is left for unprotected areas, the largest element is the local government settlement.

Neil Bibby: You mentioned unprotected areas, the biggest element of which is local government. What other services are we talking about? You have talked about the cuts to local government, which could continue. Are there any other areas under the direct responsibility of the Scottish Parliament that have seen the same level of cuts as local government?

Professor Roy: We have not looked at individual spending lines going back. That is one of the challenges with how the budget document and budget materials are presented; it is quite challenging to do time-series profiles over a large number of years.

Even within the local government figure, moneys come in and go out; for example, police and fire spending lines have come out of the local government budget in the past. We have also had the debate over whether the £250 million health and social care money sits in or outside the local government budget.

We have tried to look at local government on a like-for-like basis over the next few years and at the challenge that it has had. We also document and talk about cuts in other areas. I have not looked explicitly at whether local government has been cut by more or less, but that could be done.

Neil Bibby: In your report, you mention the need for

"greater recognition of the opportunity costs of spending decisions".

That would indicate that there is already a degree of recognition of opportunity costs in the budget process. Can you give us an example of where the Scottish Government currently weighs up the opportunity costs of its spending decisions?

Professor Roy: The principle of opportunity costs goes back to my original point. Particularly with a tight budget settlement, choosing to spend money or increase expenditure in one particular area comes with the implication that you are going to cut back somewhere else. With a commitment to substantially increase expenditure and invest in health, we argue that you need to look at that, and if such a commitment is recognised as positive and beneficial, that is fine. However, the opportunity costs of such a move are that, in a tight fiscal settlement, other budgets have to take up the slack. We suggest that, when you look at and make spending commitments, you need to think about the consequences on the other side, whether you pay for those commitments by increasing taxation, which is an opportunity cost, or making savings in other budgets.

Willie Coffey (Kilmarnock and Irvine Valley) (SNP): Professor Roy, you say on page 30 of your report that the previous chancellor's

"plan ... to achieve a surplus by 2019-20 has been abandoned."

I take it, then, that we should expect a lengthening of the austerity programme, pushing it further into the future. On the same page, you state:

"Between 2016-17 and 2020-21, the Scottish budget could fall by between 2.8% and 6.2%",

which is

"equivalent to between £700 million and £1.6 billion."

Can you clarify whether that means that, in that five-year term, the worst-case scenario could be a year-on-year cut to the Scottish budget of £300 million?

09:45

Professor Roy: On your first question about the fiscal reset and the chancellor abandoning the target of achieving a surplus by 2019-20, there is quite a lot to think about with regard to what that means. If the economy is now going to grow more slowly over the next few years, that means that borrowing will be higher than it otherwise would have been. Fiscal reset and abandoning the fiscal surplus target could happen—and probably have—without any discretionary choice on the chancellor's part, simply because he is now likely to miss the target of achieving a fiscal surplus by 2019-20 as a result of lower tax revenues or higher welfare expenditure from the economy slowing after the European Union referendum.

The plan to abandon the target could mean a lot of things. It could mean just that and no more, and there could be no other changes to tax policy, welfare policy or departmental spending policy. On the other hand, there could be a more interventionist approach; one scenario is that, in addition to abandoning the target, the chancellor could cut taxation or increase public expenditure. It is also entirely conceivable that he could choose to abandon the fiscal surplus target by 2019-20 but still make up some of the difference. If borrowing were to be slightly higher than it thought it would be, he could make additional cuts to get it down. That is why we have put forward a particular range of scenarios in the report.

The fall that we are talking about in the period from 2016-17 and 2020-21 could be between 2.8 per cent and 6.2 per cent; the 6.2 per cent figure is essentially the full fall between 2016-17 and 2020-21. Therefore, in the worst-case scenario, we are talking about a 1.6 per cent fall year on year, while in the best-case scenario, the fall is just under 1 per cent year on year. Next year's budget was due to fall by £100 million, and the scenario that includes additional consolidation adds an extra £200 million on top of that.

The one thing I would say about the scenarios is that they are intended to illustrate the scale of the challenge. We will not know exactly what will happen until the autumn statement kicks in. There is a whole feast of things happening in the report such as the outlook for the economy and inflation, which although we know is a risk is not explicitly included in our forecast. If the Bank of England continues to set an expansionary monetary policy, which is generally perceived to be a good thing in the current uncertainty, one of the consequences might well be slightly higher inflation, at least in the short term. That will increase the real-terms pressure on the Scottish budget and make some of the real-terms commitments that have been made more costly; for example, if you are protecting the police budget in real terms and inflation increases, you will have to put more cash into the police budget, which will have consequences elsewhere.

Willie Coffey: Thank you for that explanation. The budget has been under pressure and suffering cuts since 2010, and we are looking towards another period of austerity. On the point that my colleague Neil Bibby made about pressure on services, there is a feeling that services have already been cut to the bone and cannot suffer any more. Is there a real risk that some Scottish Government policies might not be able to be funded and afforded over the current five-year period?

Professor Roy: That question starts to stray into the area of political choices and commitments, which is not really an aim of the report. We are just trying to set out the numbers and the scale of the challenge. Ultimately, it comes down to choices. What is the pot of money that you have to spend and what priorities do you want to spend it on? Given Scotland's new fiscal powers, do you want to raise additional money to help pay for those priorities?

Such decisions come with the opportunity costs that Neil Bibby talked about. If you want to invest in public services and potentially counter the cut in the block grant, one option is to increase taxation. You could add a penny to income tax and raise £400 million. That is a simple illustration, but it could have consequences for economic activity and the delivery of services.

There is a variety of different things to think about. However, the question whether commitments are under pressure is not something that we touch on in the report; all we are doing is setting out scenarios and the facts of the numbers.

Willie Coffey: Even if we were to exercise the fiscal powers that are coming to us, is it possible to say whether they would be sufficient to address the scale of the cuts that we could be facing? Is it possible to do that? Did you have a look at that?

Professor Roy: No. That essentially comes back to a political choice about your priorities with regard to taxation versus expenditure. Say, for example, that we are talking about a cut of £300 million or £200 million in a year; the Scottish Parliament now has the powers to address that. As I have said, a penny on income tax would raise £300 million to £400 million. That could be done, but there would be consequences and opportunity costs in all that. The Parliament has powers to do things, but whether that is the best use of those powers is, I guess, a political question and a choice to be made.

The Convener: Patrick Harvie and Murdo Fraser have supplementaries on that area.

Patrick Harvie (Glasgow) (Green): Good morning. My question is on some of the issues that have come up in the past minute or two about tax flexibility. Does the report place too much emphasis on the rigid nature of current tax policy commitments? The commitments are taken from the Scottish National Party manifesto, and my reading of the report suggests that an assumption has been made that those are now Government policy. Regardless of which party is in power, do we not need to move away from taking manifesto commitments on tax policy as assumptions for the rest of a parliamentary session and towards an acceptance that, whichever party is in government, those decisions will be made annually given the circumstances at the time?

Professor Roy: That is a very good point. Let me be clear: we report on what the Scottish Government has said either in the programme for government or in the SNP manifesto. We have said quite transparently that we take SNP manifesto commitments as being commitments that will, at least, be presented by the Scottish Government to Parliament. Therefore, there is a consistency in what we say not only on the spending side—for example, with regard to doubling childcare or increasing health expenditure—but on the other side, too, when we refer to the Government halving what it would call the burden of air passenger duty, its commitments on council tax and so on. You are entirely right: we need to think about the flexibility of taxation policy more generally, not just on the spending side or in relation to opportunity costs, but on the overall approach to taxation and the strategic approach to raising and balancing revenue.

In the report's final chapter, we tease out some of those issues. We talk about how you might want to look at setting slightly more efficient tax systems and to think about individual tax policies that might raise different amounts of revenue. Fundamentally, that comes back to a question about the overall approach to tax and spending. The Scottish Government and the Parliament now have much greater flexibility over that, and that flexibility is not just about being able to raise income tax by 1p or 2p; instead, it is about our overall approach to, for example, land and buildings transaction tax, what we want to do with that and how we can make the system more efficient. That is a challenge and in our report back to the policy makers, we say, "You can now look at the issue completely differently." I take your point.

Patrick Harvie: Thank you. If we come on to discuss preventative issues, convener, I would like to come back in.

The Convener: Yes, we will be coming back to those issues, and I believe that Adam Tomkins will be opening the discussion when we do.

Murdo Fraser (Mid Scotland and Fife) (Con): I have a follow-up to Mr Coffey's questions about the overall size of the budget. The report comments that the Scottish Government has "unprecedented autonomy" in relation to the size of its budget and its budget choices. A theme that runs through the report is about how it will increasingly be the performance of the Scottish economy and the tax revenues generated from it that will determine the overall size of the budget. Table 2.4 on page 43 is quite striking: it shows the potential differential in the size of the budget, depending on growth in Scottish tax revenues. Have you looked at what level of economic growth would be required to avoid the need for budget cuts?

Professor Roy: There are two points to make. First, you are entirely right to say that, like it or not, the fact that the fiscal framework is set up in such a way that what really matters is Scotland's tax-per-head performance relative to that of the rest of the United Kingdom means that how well Scotland does on that measure becomes crucial for the overall outlook for the Scottish budget. The bit that will be taken out of the block grant every year will be the equivalent UK tax receipt growth. That is a burden that will always be there in the Scottish budget in the future. Therefore, how much we can add back in by growing more quickly than the rest of the UK is crucial.

With the tax powers that are coming down the line, which mean that nearly half the budget will be determined by revenues that are raised in Scotland, it will be possible for very small changes in that relationship to feed through to quite significant changes in the Scottish budget over a very short period of time. In the example in table 2.4, a differential of about 0.2 percentage points between Scotland and the rest of the UK leads, after four years, to additional revenues of £130 million either way. Therefore, that factor becomes crucial. As we move forward over a longer period, the growth performance of the Scottish economy becomes fundamental to the overall outlook for the Scottish budget.

I add a note of caution. In the short term, what really matters is what happens to the block grant, because those effects take time to materialise and are compounded every year. In the immediate term, whether Scotland's budget goes up or down is not likely to be determined on a yearly basis simply by how good our growth performance is. That is not likely to be the dominant factor in any one year, but it will become crucial over a number of years.

Murdo Fraser: I have a brief follow-up question. Your forecasts for the Scottish economy in relation to that of the UK as a whole are not particularly optimistic. Is that a fair comment?

Professor Roy: Yes. In the short term, our key conclusion is that the Scottish economy has been fragile over the past 18 months. As far as our growth performance relative to that of the UK is concerned, we have been growing at around 0.6 per cent over the past year, whereas the UK's growth has been closer to 2 per cent. That has been driven largely by what has been happening in the North Sea. Do we think that there will be a dramatic change in that in the immediate term, given the headwinds that the North Sea industry faces as it adjusts to its new normal? That is quite a challenging situation to have to deal with.

As regards the labour market, although there has been quite a sharp fall in unemployment over the last quarter, employment has been flat in

Scotland for the past year, whereas it has been growing in the UK. Brexit will be a challenge for the UK as a whole, but Scotland has the additional element of what has been happening over the past year. In our view, that means that it will be quite a challenging economic environment as the new powers gradually kick in, but we will get back to a new normal—a new level of sustainability. In the long run, the key is how Scotland does relative to the UK.

The Convener: We have a couple of themes running on the overall impact of what the UK Government does in terms of the budget level and what we should do with taxation and the block grant adjustment. I want to bring in Maree Todd to ask about the overall high-level picture, after which James Kelly will ask about taxation and the block grant adjustment.

Maree Todd (Highlands and Islands) (SNP): If I have understood correctly, over the decade between 2010 and 2020, the budget is being cut by 10 per cent in real terms. As I understand it, you said that that is a result of a political choice by the UK Government to pursue an austerity agenda.

Professor Roy: I do not think that I said that.

Maree Todd: You said that Governments have a choice in how they deal with the situation that they are in, and that the UK has made the choice to cut spending.

10:00

Professor Roy: I will come back to you on that.

Maree Todd: Okay. I might have misunderstood.

I know that, as far as the outlook is concerned, we face some challenges, but fundamentally our economy has some strong points, and the Scottish Government has a really good track record in responding to cuts. Can you say more about how the cut to the block grant is impacting on the Scottish economy and the response that we might make to that?

Professor Roy: On the general point about the choice to cut public expenditure since 2010, there are obviously two parts to that. The first is the choice about the relative balance of cuts, the scale of the pace and so on. To an extent, that is ultimately a political choice, and people will have different views on issues such as the pace of consolidation, the relative balance and welfare versus tax versus expenditure.

However, we should also remember that, at the time of the financial crisis, the UK fiscal position was completely unsustainable. Adjustment had to happen. I accept that there is a political choice to be made about how that adjustment is made, but from an economic perspective, it is simply not possible to run deficits of 10 or 15 per cent of gross domestic product on a sustainable basis. At the moment, debt is still 80 per cent of GDP, which is high according to standards over the past 50 years. Obviously, there have been times when debt was a lot higher—for example, in the aftermath of the second world war—but ultimately you have to get to a sustainable fiscal position.

How you do that and the relative balance in that respect is a political choice, and most people will accept that there had to be some degree of consolidation over the past few years. There is then a debate to be had and a view to take—and I am sure that the committee will have such a view—on whether that was too big, too small or whatever. We would not really have a view on that.

As a consequence, however, the Scottish budget will shrink in real terms over the next few years. To put that into context, I think that it will go back to, say, its 2005-06 level. That context is useful, because it shows that although the cut over the next few years will be substantial, the budget will still be at the level that it was at 10 or 12 years ago. Against that, demand for public services is higher, which puts pressure on choices and how they are made.

In the final part of our report, we start to touch on the kind of issues that you are talking about. In a world where resources are more constrained, how do you actually ensure that you deliver the public services that people want? In that respect, we highlight the importance of starting to focus on outcomes and really focusing on prevention and what matters. Instead of making commitments that relate to particular numbers of people in a particular post or to protecting or increasing portfolio lines, we need to focus on what matters to people. For example, how can we make people healthier and ensure that they do not have to access health services before we get to the point of correcting and investing in that situation? In a tight fiscal settlement at a time when demand for public services is increasing—and will just grow naturally as demographic change kicks in—what can you do to reform and be more ambitious about how you deliver outcomes and efficiencies?

The Convener: Does Maree Todd want to come back in?

Maree Todd: I think that that is all, convener.

James Kelly (Glasgow) (Lab): Murdo Fraser has already asked about the difference in tax take and how the block grant adjustment will deal with that. Just to round off the taxation part of the discussion, I note that you have mentioned a couple of times that a 1p tax rise could equate to an additional £400 million for the budget. You outline in the report the SNP's proposal/approach, suggesting that it would have a "marginal impact" on the budget. What financial value might it have?

Professor Roy: In our report, we add up the commitments that the Scottish Government has made on tax, which essentially fall into two sets.

First are commitments to increase revenue, primarily through changes to income tax thresholds and to the way in which the block grant adjustment works. That would have two effects. Increasing the income tax threshold more slowly would actually raise revenue in Scotland, but if the UK Government increased the threshold even more quickly at the same time, that would reduce the block grant adjustment. There would be a double win from that—there is a tax increase. However, we note that the Scottish Government also has commitments to cut taxation, principally to halve the burden of air passenger duty by the end of the current session of Parliament.

Taking those elements together, we estimate, based on our modelling, that it works out as an additional increase in revenue of approximately £213 million by 2021, which will be just under 1 per cent of the overall Scottish budget at that period in time. There is an additional increase to the Scottish budget as a result of discretionary tax policies of around £213 million.

James Kelly: Just to be clear, is that £213 million per year or over the current session of Parliament?

Professor Roy: It will be the amount at the end. By the time we get to 2021, that will be the additional increase—the £213 million will be there.

James Kelly: So it is a cumulative position.

Professor Roy: No—it is the end position in that year, so it is how much higher in that year the tax revenues are. The cumulative figure would be that amount plus the additional revenue that is picked up in additional years.

James Kelly: Right—so that is the final year.

Professor Roy: Exactly—it is the final-year figure.

James Kelly: Okay. I have one final point. The scenario that you paint is of a contracting Scottish budget as a result of a number of factors. We now have more taxation powers at our disposal, but the Government and all the parties must face up to quite a stark situation.

You point to the need for more discussion on outcomes. Do you think that the debate needs a more open and honest exchange of views? Politicians and political parties—I hold my hand up here—tend to get stuck in our own positions, arguing about our fixed views. Do you think that, because of the scenario that you paint, we need a better-quality and more open debate about the issues to properly address the problems that have been outlined?

Professor Roy: Yes—that is our key recommendation in the report. We go through all the stuff in chapter 4 of the report, and say that, if we are starting from a position in which we have a relatively fragile Scottish economy, a tight fiscal settlement and increasing demand for public services, we need to ask what the solution is. The solution has to be an open and honest discussion about outcomes, the opportunity costs of policy decisions and the balance that we want between tax and spend in this country. We need to be up front and frank about that.

That brings us to Patrick Harvie's point about commitments on taxation and the need to look at the more radical things that we could do in that regard and the overall structure of taxation that we want. The more we can move the debate on to that sort of thing, the more likely it is that we will end up with a constructive outcome in what is likely to be quite a challenging situation.

The Convener: That is exactly where Adam Tomkins wanted to take us in his questions.

Adam Tomkins (Glasgow) (Con): Yes, indeed, Professor Roy—I wanted to move on to chapter 4 of the report and what you have to say about opportunities, looking forward.

On page 77, you say that there are opportunities with regard to social security spending, in particular

"To better link up ... responsibilities in health, education and skills".

What role do you think that the Finance Committee can and should play in scrutinising how such opportunities are taken?

Professor Roy: That is a good point. I will make a general comment first about the social security element. That is a good example of an opportunity to look at outcomes in a completely different way, focusing on what is best for an individual and the best outcome that each individual can get, and therefore on the full spectrum of opportunities and intervention that the Scottish Government, local government, service providers and so on could provide for an individual. That could be through education, skills or the social security system. How do we get an overall package? Considering that is one of the key opportunities in the new powers that are coming to Scotland. How can we deliver services more efficiently and in a new way?

The Finance Committee's role in that is to consider whether we are spending the money in the right way to get the outcomes for an individual. We need to consider whether we are spending it once and in the most efficient way—we need to consider what gets the biggest bang for the buck that comes from our tight resources. We need to take examples from the new social security powers and ask what we are doing with them and how that complements existing interventions for individuals in a way that delivers positive outcomes.

Adam Tomkins: My second question relates directly to what you have just said. On a couple of occasions in chapter 4 of the report, you talk about the importance of effective parliamentary scrutiny of draft budget plans. You say that, given the environment that we are in,

"the importance of effective fiscal … scrutiny is more crucial than ever."

You also say that

"it is vital to protect parliament's … role in budgetary scrutiny."

As you probably know, the Scottish Government proposes significantly reduced time for budget scrutiny in this session, as I think that it did in the previous session of Parliament. Do you have any reflections on that in the light of what you have said about the importance of effective and robust parliamentary scrutiny?

Professor Roy: I fully stand by the statement that we need really robust scrutiny and examination of the issues. That is crucial. The issue that you are all wrestling with, and which the Government will be wrestling with, is how you best do that scrutiny now that the Parliament has much greater tax powers and our interaction with UK fiscal policy through the autumn statement and block grant adjustment is much more complex. Should the budget come before or go after the autumn statement? The challenge is that, if it goes after the autumn statement, the Parliament's scrutiny period will be really condensed.

I distinguish between the length of time that you have to scrutinise something and the quality of the scrutiny. What further information can the Government provide to allow really effective scrutiny over, potentially, a shorter period? Even if that does not happen, how much more information could it provide?

The Office for Budget Responsibility has transformed how people view budget documents at a UK level. Of course, you can criticise the OBR—as you can criticise us—for getting forecasts wrong, but the level of information that it now provides means that anyone can find out exactly how it came up with the various forecasts. We do not have that yet in Scotland. It would be really useful to have much more information about that.

There are also issues with the presentation of material in budgets. A common complaint and a challenge that we had is the fact that some budgets are presented with depreciation and some without it. That makes it hard to go from one part of the budget document to another. How can the Government provide much more information to capture such situations? Can we have data that shows splits between what is already committed and what is not? We know that there are large commitments in certain budgets in relation to non-profit distributing projects, private-public partnerships and wages, for instance. To have much more information on those issues would allow you to scrutinise what choices the Government has within those individual spending lines.

A lot could be done to improve the quality of scrutiny. That is the sort of thing that the new budget review group could seriously consider. What type and quality of information would enable you to scrutinise the budget much more effectively, even if the time available is relatively short?

Adam Tomkins: That is extremely helpful. Thank you very much.

10:15

Ivan McKee (Glasgow Provan) (SNP): I want to drill down more into outcomes. I also have a brief supplementary question on some of the questions that Murdo Fraser asked. If I have time, I could squeeze it in at the end, convener.

The Convener: We will see where we get to.

Ivan McKee: My first question is on outcomes and section 4.3 of your report. You talk about the way in which spending is currently handled by big departments, with everybody fighting for their finances on the basis of what they have received historically. You then discuss how that could be shifted culturally to focus on outcomes. You mention the national performance framework and how the budget lines could be linked to that. Conceptually, it all makes sense. You also talk about the quality of scrutiny. All of that ties together.

How can we get from where we are to where we need to be? Your report is 92 pages long but there are just two pages on that. You say that getting where we need to be is really important and that we need to do a lot of work and not just give it lip service. You then write two pages on that and move on to something else.

First, do you plan to do more work on that and, secondly, what should the committee do? Most of us are new to this, so we are open to doing it differently from how it has been done before. What might the scope be? As you say in the report, the Christie commission mentions a figure of 40 per cent of public spending. From my experience in the business world, I think that a target of 20 per cent is more realistic and certainly achievable. In the context we are talking about, those are big numbers. What are your thoughts on that?

Professor Roy: I think it is a really good-quality two pages, even if it is only two pages. You are right to say that getting where we need to be is not easy, and it is not the sort of thing that we can do overnight. It is something that we have been wrestling with since the Christie commission reported. For me, the importance of the data and information is that it allows us to trace through outcomes and ask how we can genuinely see where money is being spent and what it means for individuals.

Social security is potentially a good case study of whether changes could be made, because we are not starting off with any fixed positions or previous examples. It is challenging, but the more data we get, the better. There should also be a realisation that, as James Kelly said, we need to move away from fixed positions and viewpoints that are taken on something. For example, we define protection of the health budget as a portfolio responsibility with a level 2 budget settlement. We say that we will protect the health budget, whereas the question should be about how we can improve health outcomes. The answer to that could be investment in programmes in social justice or local government.

We need to get much better at linking all that information together, and data is crucial to that. There are some good examples of individual spending lines where that has been done, and the more work we can do on that, the better. That might be the sort of thing that the Finance Committee could look at, and it is definitely something that we will look at quite closely over the next few months and years.

The Convener: Ivan, can you pick up on the issues quickly, please? Two other members want to ask questions.

Ivan McKee: Yes, I will be quick. We were talking about the fragility of the Scottish economy. Chart 2.1 in the report shows that, going back two years, the growth rates in Scotland and the UK were broadly similar. Page 4 shows the historical tax growth in Scotland versus that in the UK, and Scotland has actually had higher tax growth in VAT and income tax over a 14 to 15-year period.

Somewhere in the report, you mention the potential differential Brexit impact, whereby Brexit could have a higher impact on the rest of the UK than on Scotland because of the sectors that the rest of the UK is involved in, because of finance and because the rest of the UK is geographically closer to Europe. Comparing UK growth rates with the growth rate in Scotland is fine in the context of the block grant adjustment, but is there not a more interesting comparison to be made with the historical growth rates of other small European countries, which have been significantly higher than Scotland's?

The Convener: Thanks for the short question.

Ivan McKee: You should hear a long one.

Professor Roy: There were three parts to that short question. You are entirely right that we are looking at a short-term horizon for the Scottish economy given what has happened over the past year. For this budget and this Parliament, that is probably the crucial bit.

You are also entirely right that, since devolution, Scotland has done relatively better on many indicators than the rest of the UK, tax revenues being an example of that. The question is whether that situation is likely to continue, and that is where we have concerns about what has been happening over the past year. If the situation continues in the short term, it could have an impact on the Scottish budget.

We compare the growth rate in Scotland with the growth rate in the UK deliberately because that is what matters to the fiscal framework—that is the crucial bit. The way that the fiscal framework will work is that Scotland's budget will be better off relative to Barnett if Scotland's tax receipts per head grow more quickly than those in the rest of the UK. You may disagree with that framework and starting point, but that is the way that the framework will work.

Making comparisons with other small, comparable countries is an interesting exercise—there are a lot of issues in there—but, from a fiscal framework point of view, that is almost irrelevant, because what really matters is the comparison between Scotland and the rest of the United Kingdom.

Ivan McKee: I am interested in potential growth rates.

Professor Roy: The position of potential growth rates is relative in the sense of what you might do with the levers and so on, but the comparison ultimately comes down to Scotland and the rest of the UK.

We predict growth of 0.5 per cent in Scotland next year. The average forecast for the UK for next year is about 0.7 per cent, so we predict slightly slower growth in Scotland than in the rest of the UK.

The Convener: That takes us a wee bit away from the chapter 4 issues that we wanted to ask about. Other members want to speak. I apologise to Ash Denham—I have not managed to get you in on Brexit, Ash, even though that was raised as part of the question that was put by Ivan McKee. We will come back to you.

Patrick Harvie: I want to compare the arguments in chapter 4 around outcomes, prevention and so on with the approach that you take in chapter 3, in which you look at the Scottish Government's spending commitments.

When you examine, for example, childcare and health spending commitments, there seems to be an implication that the important issue is the consequent additional squeeze on unprotected areas—that is, the additional cuts that will happen as a result of those commitments. How do you take account of the other savings or more beneficial impacts on the Scottish budget of that kind of spending? For example, we know that such social infrastructure can enable people to become more economically active and can reduce the costs of poverty—which are a financial cost to the Scottish Government as well as a human cost—and that it can even, within an overall envelope, ensure that some of the worst effects of that burden do not fall on those who are least able to cope with them. How have you taken account of the arguments that you make in chapter 4 in your methodology in chapter 3?

Professor Roy: That is a very good point. Essentially, the document comes at that question from the other direction. It takes a mechanistic approach of looking at what happens at a portfolio level and what happens in the overall budget, and it shows what the challenges are within the unprotected areas and so on. Then, in chapter 4, we square the circle by coming back to the point that you make and asking, "In this environment, both presentationally but also in terms of the delivery of public services, what is the solution to this?" The solution is to do exactly what you are talking about and ask how we can focus on outcomes and preventions so that, when there are consequences of changes in individual portfolio lines, we see the wider implications in terms of demand for public services and so on.

I sound two notes of caution within that. First, what is the likelihood that you will get those benefits in the short term? That issue needs to be borne in mind. Secondly, will the investments in those areas deliver changes in the outcomes? We know that investment in childcare leads to long-term benefits and improvements in other services, but there are interesting policy questions about, for example, what you would spend the extra money on in health. Would you use that money to put in place social infrastructure or health infrastructure that would lead to the benefits that you mention? The challenge is in how you use the money in the protected areas most effectively to deliver better outcomes that mean that demands in unprotected areas might fall or that savings might be made.

Patrick Harvie: So, the institute is not yet at the point at which it can take some of these spending commitments and make an assessment of the potential positive consequences.

Professor Roy: We could do that, but that not is what the report does. As I said, the report takes a mechanistic approach and shows what that investment means for various areas. At that point, we get into interesting questions about what the money in health is spent on, which leads to the issues around prevention.

We are interested in looking at how the concept of inclusive growth is approached in the framework that we have. The way in which we would traditionally do that in economics does not capture all the benefits of inclusive growth and how we develop it, although that is the really interesting bit to look at and will probably be the next part of the exercise. Patrick Harvie is right in saying that how we look at the spending below the higher level will be crucial. For example, if the health budget rises by £500 million, the question will be how that can best be used to benefit outcomes across the board.

Patrick Harvie: I suspect that that only underlines the argument that Parliament should have enough time to take ample evidence—a wide range of evidence—when a draft budget is published.

James Kelly: Let us return to the section on transparency. On the presentation of the budget, you make the point that, when the documents are released into the public domain, they are in PDF format as opposed to Excel format. Some people might feel that that is a minor point, but I think it is an important one. You spoke at the start of the evidence session about how you have built up your team in recent months and have a good number of experts. However, in order for you and other stakeholders to analyse the budget quickly and in the best way—particularly if we are going to look at it in a curtailed timescale—should the Scottish Government not consider, as a matter of priority, publishing it in Excel?

Professor Roy: That would be a helpful step. As I said, the OBR publishes in a transparent way all its Excel data and every chart and table that it produces. That is a very simple thing to do, but it enables very quick analysis and scrutiny of what is going on.

The wider point that we make about transparency is that the framework that we are going to get will be exceptionally complex. There will be challenges between forecasts, revisions, money moving from reserves into budget outturns, the forecasts for the BGA, the forecasts for the Scottish tax revenues, reconciliations and borrowing for cash flow—it is going to be exceptionally complex. The only way in which you will get effective scrutiny and, crucially, trust in the system is by having all of that transparently set out so that you will know, three years from now, for example, that the reason why a budget is falling is that there was a forecast error four years ago. You need to have the information in order to do that scrutiny and so that people will trust it. If you thought that Barnett, with all its complexities, was difficult you ain't seen nothing yet.

The Convener: Wowser.

Ash Denham (Edinburgh Eastern) (SNP): Good morning. The institute has modelled the potential effects of Brexit on the Scottish economy. You have summarised that work by saying that you think that Brexit will have significant negative effects on the economy and that GDP over the next decade will be between 2 and 5 per cent lower as a result. Can you expand on that comment? I assume that it takes into account an expected reduction in international investment in the Scottish economy. We know that Scotland has been doing quite well in that regard and is the second-biggest location for such investment outside London and the south-east. If foreign direct investment is considered to be a driver for things such as productivity and innovation in the Scottish economy, should we be concerned if the level of such investment is lower? Obviously, the level of productivity in the economy will be lower because of the consequences of Brexit.

Professor Roy: In that context, it is important to bear in mind a couple of points. Our modelling looks at what impact the shock of Brexit might have on both the Scottish and UK economies over the long term. There is quite a debate about the scale of that shock and whether its impact will be positive or negative. Most economists believe that it will have a negative impact in the long run because it might have implications for trade and so forth. Taking that as a starting point, we say in the report that there will be a slightly negative impact on Scottish GDP, which will be between 2 and 5 per cent lower than it would otherwise have been.

There are a couple of factors within that. As you rightly point out, there are potential implications for investment. Scotland has done relatively well on international investment in recent years. If such investment were impacted in some way by Brexit, that would potentially have a disproportionate impact on Scotland relative to the impact on the rest of the UK, which would be a concern if it were to feed through to productivity and so forth.

10:30

On the other hand, it is important to note that that assumes that policy will remain constant. We do not know what may happen in the future, in a post-Brexit world. Policy might change and new trade deals might be arranged, which would change the growth trajectory. Another thing that is crucial in the context of the fiscal framework is the impact of Brexit on Scotland relative to its impact on the rest of the UK. As I explained, the growth in UK tax revenues relative to the growth in Scottish tax revenues is crucial. If we could grow more quickly or fall less slowly, we would be better off relative to where we were under Barnett. Interestingly, in our modelling we find that the negative impact will potentially be slightly less in Scotland than it will be in the rest of the UK because the UK has slightly more trade integration with the rest of the EU. If we take that for what it is, it might mean that, in the medium to long term, because of the way in which the fiscal framework works, Scotland would be less impacted than it would be otherwise.

There are quite a lot of complex issues, but the basic point is that Brexit will have a negative impact on the Scottish and UK economies. The crucial thing under the fiscal framework will be whether Scotland is more or less impacted than the rest of the UK. Some areas, such as investment and productivity, could be a concern and might make things worse, but our estimate, which is based on our modelling, is that the impact will be slightly less in Scotland than in the rest of the UK.

Murdo Fraser: One question that has not been touched on so far relates to the Scottish Government's capital spend. On page 68 of your report, you comment on the fact that the Scottish Government has new borrowing powers for capital spend in 2015-16 of up to 10 per cent of the capital DEL budget, which would be around £300 million. So far, the Scottish Government has not utilised that capital borrowing. Do you expect it to be used by the end of the year or is there any indication that the Scottish Government is struggling to find projects to spend the money on?

Professor Roy: I do not know about that. My assumption is that we would expect to see the use of borrowing powers towards the end of the financial year, because the Government might as well use all of its capital DEL first. I expect that there might be a trend for any Administration to tend to use capital DEL in the first part of the year and then unlock the capital borrowing powers towards the end of the financial year. From an accounting perspective, that is what I would expect to see. I do not know whether there is an issue with capital projects.

The Convener: I said earlier that I would like to ask a quick question about structural slowdown issues and how those play out against the fiscal framework. Your report highlights the risk to Scotland's economic performance should the recent North Sea oil slowdown prove to be part of a more sustained picture. You describe the

"lack of fiscal support mechanisms to counteract an asymmetric structural decline in a sector that Scotland is more heavily concentrated in"

as a

"weakness embedded within the new fiscal framework."

You note that

"there are no new mechanisms to protect devolved services during sustained structural slowdowns",

which is pretty worrying. As a result, you conclude that

"Scotland's budget is now much more exposed to risks that the Scottish Government has limited ability to mitigate."

In your view, what is necessary to increase the Scottish Government's ability to mitigate the effects of such structural issues?

Professor Roy: To be clear, we are saying that, under the fiscal framework, if there is a cyclical asymmetric shock, which is purely temporary, the Scottish Government has revenue borrowing powers to deal with that. If there is a shock where Scottish GDP growth is less than 1 per cent and more than 1 per cent away from that in the rest of the UK, those asymmetric borrowing powers can be unlocked. The point that we are trying to make there is about what would happen if there was a long-term shock—if a sector in which Scotland had disproportionately more invested than the rest of the UK went through not a cyclical change but a structural change. What mechanisms are in the fiscal framework to deal with that? There is nothing directly in the fiscal framework to deal with that.

On the reserved side, there is still the insurance mechanism that North Sea revenues are collected at the UK level and unemployment benefits, for example, are still at the UK level. There is a mechanism there that helps to smooth the structural adjustment. However, purely on devolved services, if there is a decline in a sector that reduces income tax revenues, employment and earnings, there is no automatic mechanism to deal with that.

That sort of thing would be a challenge. It could be argued that the Scottish Government could use its new powers—its capital borrowing powers or its tax levers, for example—in a more effective way, but an immediate response could not be provided through the fiscal framework. Therefore, if you wanted to make an adjustment, you would have to change devolved services, taxation or borrowing. There is not an additional mechanism such as the cyclical mechanism that exists in the fiscal framework to deal with such a situation.

The Convener: If there was a long-term structural issue across the UK, what mechanisms would the UK have to deal with that impact?

Professor Roy: There are two things. First, it could obviously use greater borrowing powers over a period of time.

Secondly, with the fiscal framework, if the UK had a structural challenge, UK revenues as a whole would decline and, in turn, that would mean that the block grant adjustment would decline, as well. If the shock was shared and it was identical in Scotland and the rest of the UK, Scottish tax revenues would fall, but the block grant adjustment would also fall. Therefore, the net effect would be zero. The challenge is in Scottish tax revenues being suppressed by the shock but the block grant adjustment not being affected by it, because it is a much smaller fraction of the UK economy.

The Convener: Is your institute looking at that particular issue more deeply, or are other institutes out there doing such work? Obviously, that will be quite an important issue in the longer term.

Professor Roy: Yes, we are looking at that. We are developing our economic modelling in the Fraser of Allander institute. We are now extending the models that were developed to look at the Brexit shock, for example, to build the fiscal framework into them so that we can look at what happens if there is an asymmetric structural shock between Scotland and the rest of the UK, the potential long-term economic implications of that, and the long-term benefits of being able, if the economy can be grown more quickly, to recycle revenues over and over again into public services and the wider economy.

Patrick Harvie: I assume from what you are saying that if, for example, a hard Brexit scenario resulted in a similar shock to financial services, that would clearly have some effect in Scotland, but it would have a much bigger effect in the rest of the UK. Therefore, that kind of asymmetric shock in the other direction would have a positive effect in Scotland. Is that a correct assumption?

Professor Roy: Yes, exactly. That is the asymmetry. In that scenario, the block grant adjustment would be much smaller than it would have been and Scottish tax revenues would be less impacted by that. Therefore, there would be an asymmetric shock in the other direction. The key point is that asymmetry is built into the potential system and the Scottish Government now faces additional risks on both the up and down sides that it does not have the levers to control or address.

Patrick Harvie: Thank you.

The Convener: I am sure that we will need to examine that issue a bit more at some stage in the future. Obviously, we do not have time to go into that level of detail today.

On the issue of transparency and the information that is available, what level of macroeconomic data—economic growth data, for example—should the Scottish Government prioritise and should we expect to see published? What would help us in that area?

Professor Roy: There are a number of things. On the economy side of things, you want to scrutinise the assumptions that underpin the modelling. Models are models and they will give you a number, but what you put into those models is crucial, and that is something that the OBR has done really well. It sets out all the assumptions behind how it comes up with its results. That is crucial, because it tells you why you are expecting Scottish growth to be faster or slower, for example, and you can trace the effects.

You could do with information of the type that the OBR produces on the economic side. That would be useful to have. What are the key determinants of future land and buildings transaction tax revenues, for example, and what are our assumptions about them? Are those assumptions reasonable? Answering those questions allows you to scrutinise things. If you see that revenues are growing quickly you will know why, because of assumptions about faster house price growth or an increase in the number of houses, for example. That sort of information is crucial.

Secondly, there is the information that you want on the fiscal side of things. We touched already on information in budget lines, and there is also the issue of non-cash versus cash and where the discretion is. There are also bits of the budget that have been committed, such as NPD and PPP commitments. You know that they are locked in, so you should ask how much of a share of a portfolio budget they will take. Will they take a large or small share of the education portfolio budget, for example? Knowing those things will let you scrutinise and know what the opportunities are to do something different, and let you know how constrained you are.

Thinking about both the economic side and the fiscal side—the budget side—would be useful.

The Convener: I do not see anyone wanting to come in with a supplementary, so I thank Professor Roy for what has been a fascinating and illuminating session. I certainly found it very interesting.

The next meeting of the committee will take place on 28 September, when we will take evidence as part of our inquiry into the first year's operation of land and buildings transaction tax.

At the start of the meeting, we said that we would take the next agenda item in private, so I close the public part of the meeting.

10:42

Meeting continued in private until 11:45.

This is the final edition of the *Official Report* of this meeting. It is part of the Scottish Parliament *Official Report* archive and has been sent for legal deposit.

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