OFFICIAL REPORT
AITHISG OIFIGEIL

Finance and Constitution Committee

Wednesday 2 November 2016

Session 5

The Scottish Parliament
Pàrlamaid na h-Alba

Wednesday 2 November 2016

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FINANCE AND CONSTITUTION COMMITTEE
9th 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 David Bell (University of Stirling)
Professor David Heald (University of Glasgow)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Finance and Constitution Committee

Wednesday 2 November 2016

[The Convener opened the meeting at 10:00]

Decision on Taking Business in Private

The Convener (Bruce Crawford): Good morning and welcome to the ninth meeting of the Finance and Constitution Committee in session 5. I give apologies on behalf of Alex Johnstone. Please switch off mobile phones or switch them to silent mode.

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

Members *indicated agreement.*

Public Finances and Economic Performance

10:00

The Convener: Item 2 is evidence as part of our pre-budget scrutiny of the public finances and economic performance. We have two witnesses with us today: Professor David Heald from the University of Glasgow, and Professor David Bell from the University of Stirling. Would either of you like to make a quick opening statement or are you happy just to go straight to questions?

Professor David Bell (University of Stirling): I have a short statement.

The Convener: If it is a short one, please go ahead.

Professor Bell: I thank you for the opportunity to speak to the Finance and Constitution Committee again. I do so at a time of greater than usual uncertainty around the public finances. Brexit plays a part in that uncertainty, but there is also considerable uncertainty around the United Kingdom Government's economic and industrial strategy. The key short-run consideration for Scotland is how that might affect the UK fiscal stance and, therefore, Scotland's budget.

My argument, which I outline in my paper, is that the full economic effects of Brexit will take some time to emerge. Recent statistics on UK economic growth confirm that conclusion. One key exception, though, has been the depreciation of sterling, which has been sudden and dramatic. Financial markets are always quicker to react than the markets for goods and services, and sterling's depreciation reflects the markets' long-run view of the UK's economic prospects. That depreciation is likely to lead to a rapid rise in inflation, which I mention in my paper and which the National Institute of Economic and Social Research forecasts today will rise to 4 per cent. That will almost certainly lead to a decline in real incomes because wages are unlikely to keep up with that rate of increase in prices. That is likely to lead to a slowdown in the economy tomorrow.

Although the UK economy is performing quite well, the tax revenues that it is generating are not performing as well as might be expected, given the economy's rate of growth. That means that the reduction in the UK's fiscal deficit is less than the Office for Budget Responsibility's March forecast, which leaves the Chancellor of the Exchequer in a difficult position when it comes to his autumn statement. He has suggested that he will not be as zealous as Mr Osborne in trying to cut the deficit, but he is already overshooting his target.

Meanwhile, huge pressures are building on the public finances in health and benefits, as we have seen today, and on the criminal justice system in England, as we have also seen today. The chancellor might react to that by doing a reset of the public finances and giving himself longer to achieve a balanced budget, or he might go for a balanced budget only as far as current spending is concerned. If he goes for the latter, he might be able to increase infrastructure spending, which would mean more capital spending for the Scottish Parliament but not necessarily additional current spending.

The last section of my paper is really off the point, but there is a very strong case for reducing the autumn statement to maybe a stock-take of the economy, rather than using it to introduce new fiscal measures. There is no need to have two fiscal events per year. That position has already been made clear by the Chartered Institute of Taxation, the Institute for Fiscal Studies and the Institute for Government. It is my view that the Scottish Parliament should swing behind that move to have the autumn statement downgraded, because that would get over a huge problem of the timetabling of Scotland’s budget.

The Convener: Thank you. On page 4 of your paper, you comment about the impact of the decline of sterling’s value on the UK economy since the Brexit vote, which you just have touched on. Would either witness like to highlight any impacts on the Scottish economy resulting from that decline that are more significant or more extended than they would be for the UK economy? Much of your paper concentrated on—for obvious reasons—the UK, but understanding the impact on Scotland would be helpful. If either Professor David has a view on that, it would be helpful.

Professor Bell: I suppose I would approach that question by thinking about where the Scottish economy is significantly different in its structure from the rest of the UK, and the extent to which those differences are susceptible to changes in the exchange rate. The food sector is probably more important to Scotland and is likely to benefit while we can continue to trade freely. The tourism sector is more important to Scotland, so it will probably benefit, too. Also, our oil industry costs being largely—but not completely—in sterling and the revenues in dollars may help that industry somewhat.

On import dependence, it is not entirely clear to me how Scotland differs markedly from the rest of the UK or what parts of Scottish industry would suddenly have big increases or hikes in their costs because of sterling’s depreciation. It may be the case that Scotland is less involved in very complex supply chains than the rest of the UK. For example, the car industry imports components from all over the world, adds value, then exports them back all over the world. Scotland does not have sectors that are quite as complex as that and where it is quite difficult to figure out what is happening. When it comes to negotiating Brexit, that issue—which is very important for many sectors of the UK economy—may not seem quite so important for Scotland.

Professor David Heald (University of Glasgow): I add that although the effects since the referendum do not seem to be particularly pronounced in terms of gross domestic product, the effects on the exchange rate are really quite significant, because they reduce the prosperity of the UK and what it can buy abroad. In the medium term—perhaps not in the short term—households will be worse off, and one would expect public spending to be lower. Therefore, even if in the short term there is a fiscal loosening, the medium-term to longer-term prospects will become worse.

The Convener: Is there any particular way that potential impacts would hit Scotland more than they would hit the rest of the UK?

Professor Heald: We are in an incredibly uncertain position about the effects and about future trading relationships. A significant point is that this has coincided with a fundamental change in how the Scottish Parliament gets funding. There is obviously much more uncertainty attached to the future of revenues here, particularly the linkages through the fiscal framework, than there is to what happens to the rest of the UK.

We have come into a period of very much greater uncertainty, in moving from what was largely a block grant funded system to one in which interconnections with the UK budget are much more complicated. The fact that we do not have the draft budget for 2017-18 shows how that change of linkage can be very disruptive. In the past, it was very easy for the Scottish Government to have a rough idea of the effect of a particular budget event, other than a spending review. That is no longer the case.

David Bell has already made the point about abuse of the autumn statement as a second budget event. When George Osborne was Chancellor of the Exchequer, he managed to have four budgets within 12 months. The parliamentary scrutiny side of the UK Parliament is dreadfully bad. No one really cares very much about that, because it suits whichever party is in office or thinks it might be in office in the future. I have recently given evidence to two Westminster committees: once on supply procedure and once on use of Government accounts. There are very obvious technical things that could be done to improve Westminster scrutiny, but there is not much sign that anything will ever happen.

The Convener: That is encouraging. [*Laughter*.]

David Bell touched on the block grant adjustment in his opening remarks. Do you have any concerns about the baseline adjustment for the block grant adjustment for income tax in the financial year 2016-17, in terms of receipts, given the Brexit implications? I would like to unpick that a wee bit more.

Professor Bell: It is difficult to separate out the Brexit implications from other things that are going on—for example, the decline in the oil industry, which is a separate shock that is clearly hitting Scotland quite differently from the rest of the UK. It is more difficult to see a differential Brexit effect that distinguishes Scotland from the rest of the UK.

One thing that would be of concern to the UK Government would be a significant collapse in the financial sector: the reduction in employment would be dwarfed by the reduction in tax revenues because of their importance to the UK economy. The financial sector is the one that notably produces the highest earners. The top 1 per cent of earners in the UK contribute 26 per cent of the income tax revenues. Therefore if a significant fall in the number of those high earners, who are mainly associated with the financial sector, happened more in London than it did in Edinburgh, that would potentially benefit Scotland. That is because what matters, as far as the block grant adjustment is concerned, are the per capita income tax revenues. Relative movement in those is what really determines how the block grant will be adjusted. Taking that a step further, what the per capita tax revenues are particularly dependent upon is not the average but the people at the top, because they contribute so disproportionately to the overall income tax revenue.

Therefore I have noted that an eye should be kept on how the financial sector fares in terms of those negotiations and, of course, the passporting issue—which is very important for services—and how that may be resolved. It seems to me that 2016-17 might go badly for Scotland if there are still effects coming through from high earners associated with the oil industry.

Last night, David Eiser pointed out to me that the number of people who are around three-quarters of the way up the income schedule did not increase as rapidly in Scotland in the year to April 2016 as it did in the rest of the United Kingdom. Actually, there was a noticeable difference in the Aberdeenshire area in that regard.

Different things are going on. However, in terms of the relative movement in per-head income tax revenues, you have to keep a very close watch on the top end of the income distribution.

10:15

Professor Heald: Over the past 35 years, I have made a good living out of trying to persuade people that the Barnett formula is not that complicated. I think that the Scottish Parliament is going to have a great deal of trouble explaining to the people of Scotland how the system works.

The Convener: Can you say a bit more about that?

Professor Heald: The level of public understanding of how the public finances of the UK and Scotland work is not high. That is a fairly general problem in industrialised democracies, but I think that the UK has a particular problem in that regard. The scale of the UK problem is perhaps a result of the fact that the House of Commons does not vote the supply estimates until well into the financial year, and they are not actually presented until the year has already started. There is a sense in which parliamentary scrutiny is not taken seriously.

In technical terms, the UK is actually very good with regard to public spending. However, it manages to combine those good technical procedures with a lack of attention to scrutiny and to justifying itself to the wider public in relation to the processes of the public finances.

For the past 40 years, I have been in favour of a Scottish Parliament with devolved tax powers. However, as I have said to this committee and its predecessors, one of the things that always worried me—and which I was deeply worried about before the Scotland Act 2016—is that lots of people seem to think that more tax powers means more spend. For the reasons that David Bell has mentioned, we have got those tax powers at a particularly difficult time. We have to communicate clearly that the tax powers that Parliament has been given are a substitute for part of the block grant that it previously received, and that having the tax powers and using them in a neutral position does not mean more or less expenditure. The only thing that is happening is—as Graeme Roy said when he gave evidence to the committee—we are going back to the level of public spending that we had in 2005-06. When people have been used to rapid increases in public spending, our talking about going back to the position that we were in 11 or 12 years ago is serious.

You will notice mounting discontent about various public service sectors—health, transport or whatever. One of the reasons for that is that people got used to rapid year-on-year increases in public expenditure. That inevitably had to come to an end, but it has come to an end very abruptly—we have gone from 4 per cent, 5 per cent or 6 per cent growth a year to zero growth or negative growth. We are in a difficult context in which to explain to the people of the United Kingdom and Scotland what is happening. Obviously, the uncertainty attached to Brexit complicates that even more.

Professor Bell: I will add that between 2005-06 and now there has been a considerable shift in public spending towards certain groups that have done reasonably well, notably older people, and against some groups that have done relatively badly, namely working-age people who are dependent on benefits.

The fact that a very significant demographic shift is taking place concurrent with the difficulties that we are facing in expanding the real value of public spending means that, as David Heald says, issues are breaking out about rationing in some parts of the public services and about not being able to meet the expected levels of service and so on.

Adam Tomkins (Glasgow) (Con): I will pick up directly on that point. I have a couple of questions about what the Fraser of Allander institute's "Scotland's Budget—2016" report, which came out about six weeks ago, says about exactly the issues that you have just talked about. The Fraser of Allander report says that the fiscal powers that are coming to the Parliament under the Scotland Act 2016

"provide a set of tools to vary revenue but also to achieve wider objectives around re-distribution, growth, efficiency and the overall balance of tax and spend in Scotland."

It suggests that there is raw meat to the powers and that the fact that the Scottish Parliament will raise so much of its money from taxation rather than directly from a block grant has the advantage of giving it more flexibility about how it manages the economy. However, the report also states, looking at the costly spending commitments that the Scottish Government has already made for this Parliament, that

"bold and radical solutions will be needed. Business-as-usual is not an option."

Do you have any reflections—positive or negative, critical or otherwise—on those remarks in the Fraser of Allander report?

Professor Bell: The Scottish Government now effectively controls around 40 per cent of the total tax revenue generated in Scotland. Income tax has not really been changed very much for many years.

Adam Tomkins: Thresholds are changing.

Professor Bell: The thresholds change, but the rates do not change. It is certainly open to the Scottish Government to introduce new bands. There is no question but that it could do that and generate additional revenues from so doing. As I implied in my previous answer—this is also true of the UK as a whole—the Scottish Government has become dependent on a very small number of people to generate a huge proportion of total income tax revenues. We do not know what the behavioural impact would be of changing, say, the very top rate of income tax and what effect such a change might have on revenues. I am going to a meeting this afternoon at the University of Glasgow with Alan Manning from the London School of Economics, who wrote a paper about a change in the top rate of income tax from 45p to 50p in the pound. His analysis is that the change basically had no effect on revenues. One has to be very careful about the use of those powers.

One could certainly introduce new bands and spread the costs of income tax somewhat more down the income distribution. That has essentially been the Scandinavian solution to having high provision of public services. There are not very high top rates in those countries but there are more progressive rates, because intermediate bands have been introduced to income tax. Such an approach has potential, although political issues would obviously have to be got round to move in a radically different direction. That would be seen as radically different, and one does not know how businesses and taxpayers would react.

Professor Heald: As a precursor to what I am going to say, I will state that my long-term support for fiscal devolution has been on an accountability basis. I have always been very uncomfortable when people argue that the Scottish Parliament could make an enormous amount of difference to the economic performance of the Scottish economy, given that most of the levers remain with the UK Treasury and with the Bank of England and monetary policy. However, there are constructive things that the Parliament can do. The Parliament got rid of the slab structure that was inherited from stamp duty land tax, which was a constructive tax reform that the UK was incapable of making.

To pick up on David Bell's point, I have long thought that the jump from the 20 per cent income tax rate to the 40 per cent income tax rate is too abrupt. There has obviously been an argument about simplification. At one point, the UK went to only two rates of income tax, which in my view was going too far.

For the UK, there is also the question of the relationship between income tax and national insurance contributions because, whatever the paraphernalia around them, national insurance contributions are essentially a second income tax.

Adam Tomkins: The Fraser of Allander institute is clearly calling for "bold and radical solutions". Would you join its call? Would one such bold and radical solution be to finally address something that we have talked about for a long time in

Scotland but have done very little about, which is to think much harder about outcomes in relation to tax and spend and less about targets?

Professor Heald: I have always been in favour of looking at outcomes but I think that outcomes are significantly more difficult to measure and to attribute to particular policies than people often claim.

There are two issues. One is a somewhat coded reference to commitments of the present Scottish Government on things such as bridge tolls and free prescriptions. However, the more significant point is about having to come to terms with what will be a fiscally difficult period, where growth in spending will be low, even if it is positive.

When people start talking about radical change, I want to know what the body of that radical change is before I am willing to express a view about it. The Parliament can do incremental things with its tax powers, but it is important not to oversell what it can do with them to improve the growth of the economy, when that will be affected much more by UK policy, monetary policy and Brexit. We need to think about how we can get more coherent policy in ways in which the UK has not been able to get it.

Professor Bell: I agree with David Heald. I do not think that outcomes and radical change in the fiscal structure are necessarily related. There is a strong case for focusing more on outcomes than we already do but, as David says, they are incredibly difficult to measure. I am not convinced that we make enough effort to do that.

The committee has spent some time—as did the Christie commission—arguing that preventative spending is an appropriate way to approach the distribution of scarce public finances. However, I have never really been convinced that the Scottish Government has enough evidence to prove the efficacy of so-called preventative spending in reducing the sort of firefighting to which a lot of our public spending is addressed.

Adam Tomkins: Thank you.

10:30

James Kelly (Glasgow) (Lab): Professor Bell, you mentioned in your opening statement and your written submission the impact of inflation and the potential exposure that that would give. What are the particular pressure points around inflation in relation to the Scottish economy and the forthcoming Scottish budget?

Professor Bell: Again, I am not sure that I can really point to massive differences between Scotland and the rest of the UK, but one possible difference is in energy costs, particularly those associated with transportation.

My main concern about inflation is that it will hit poorer segments of society harder. That is partly because of energy costs—both transport and heating costs—which will inevitably rise, as gas and oil prices are determined by world dollar prices, and partly because of the costs of food, much of which is imported into the UK. Intense competition between retailers can hold back price increases only for so long, so price increases will eventually feed through.

We have to think about the import content of public spending. A lot of current spending has limited import content. Maybe it is more important to think about the capital spending on equipment that comes from overseas and that is necessary for our hospitals, our education system and so on. Those are areas in which the Scottish budget will potentially be hit. I do not see Scotland being significantly different from the UK as a whole, but that will add to Government costs, which will in turn make the problem of balancing the budget that bit more difficult.

Professor Heald: Potential wage settlements will be one of the significant influences. We have all psychologically got used to a period of very low inflation. The 4 per cent rate that David Bell mentioned is well outside our recent experience. One would expect industrial relations and recruitment difficulties, for example. The UK has been pretty successful in holding down public sector wages as a way of controlling public expenditure, but there is a limit to how far that can go.

Professor Bell: You will see a shift of labour towards exporting industries, because they will be able to afford higher wages, whereas industries that trade mainly in the UK will not be able to do so.

James Kelly: Those points are interesting. I know that my colleague Patrick Harvie has some specific questions about that, so I will not overlap in that area.

Is there potential for a lag effect in that the draft Scottish budget will be published in December but, from what you have said, there will potentially be inflation pressures over the course of the next financial year? The budget that is drafted and set in December might well face exposure to increasing inflation, which would put pressure on the figures that were estimated—and maybe underestimated—at the time.

Professor Heald: Yes. I think that public expenditure management will be very difficult in 2017-18.

Professor Bell: With all those price increases coming through, there is the difficulty of momentum in the retail market, for example, to increase food prices, because none of the supermarket chains wants to be the first to increase prices.

Hedging is also an issue and it is currently very important in relation to energy prices. The big six companies hedge their energy prices substantially. They have bought gas and electricity well in advance, whereas the smaller, newer companies have not done that—some of them trade almost at spot prices. The consequence of that is that one or two of those companies have had to introduce huge price increases in the last few weeks. The effect will be lagged. The price increases will take time to feed through to the public purse, but the reaction will depend on the nature of hedging in the different industries.

James Kelly: Thank you.

Maree Todd (Highlands and Islands) (SNP): I was interested to read Professor Bell's comments on the future of the autumn statement. You will know that the budget review group has discussed many times the timing issues for the Scottish budget caused by the UK Government's late autumn statement. I was particularly struck by the statement:

"There have been simmering concerns over the process of forming tax policy in the UK for some time. It has numerous flaws including its complexity, lack of consultation and administrative burden. The formation of tax policy in the UK compares badly with that in other jurisdictions.

You have both addressed the issue already, and I am sure that we all agree with your call to downgrade the autumn statement to something that more resembles a stocktake.

I am interested in Professor Heald's comments on the link between the sense of parliamentary scrutiny not being taken seriously and the public understanding of how public expenditure works. In the Scottish Parliament, we take scrutiny very seriously and we are keen to engage with the people of Scotland to help them to understand how it all works. Can you reflect on that?

Professor Heald: The point about the autumn statement is that having budget events at Westminster enhances the profile of the Chancellor of the Exchequer who is in post. One of the attractions of having four budget events a year is that the chancellor gets more attention. The present chancellor may introduce a change of style, so I should qualify slightly what has been said before. We should move to a regime in which there is one budget a year. There may well be another event because of economic developments—Brexit brings so much uncertainty that it may be needed—but that should be regarded as unusual and reflective of the fact that there are specific circumstances. Another budget event should not just be opportunistic.

There are reasons why the Scottish Parliament handles the budget process much better. The Scottish Parliament had a clean start. One of the pieces of public service of which I am most proud is my membership of the financial issues advisory group in 1998, because FIAG did a good job and Parliament took its recommendations forward very effectively. Westminster finds it difficult to cast off past procedures.

As I said, there is a big issue with communication to the Scottish people of what the enhanced fiscal accountability of the Parliament means. That brings additional risks and certain opportunities, but it does not bring more spend. My fundamental worry about the way in which the tax powers debate is being publicised is that it is often understood to mean more spend, whereas it actually represents a substitution of revenue sources.

Professor Bell: I agree with David Heald's point about the chancellor. It seems that, in recent years, the autumn statement has served to enhance the role of the chancellor relative to other parts of the Government, which is not necessarily a good thing. There is concern about parliamentary scrutiny, but there should also be concern about the involvement of other arms of the Government in the setting of fiscal targets. One argument is that the chancellor should set only an envelope for public spending and individual departments should set their own priorities within that. However, it seems that recent chancellors have very much stepped into the space occupied by different departments, which has had a negative effect on morale within those departments apart from anything else.

There is also the question of whether we should be going wider than the Parliament. If we believe that the tax system exists to encourage economic efficiency and equity over the long run, everyone has a right to have their say about how it should be designed. However, the other view is that the tax system exists to respond to current events. It has to do that in some circumstances, but that is not how we should envisage the tax system working. In recent years, there have been spur-of-the moment decisions involving patches here and there or a new incentive to do this or that, which has added hugely to the complexity of the system. That makes for bad decisions that sometimes have to be reversed within months; places burdens on other departments, particularly Her Majesty's Revenue and Customs; and creates mountains of work for accountants and lawyers, which is—I hesitate to say it—not necessarily a good thing.

The Convener: We are addressing budget review issues at the moment, and you will both be aware that we have a budget review group that is a tripartite organisation set up between the Government, the Parliament and outside experts. Given your reflections on process and scrutiny, what do you think should be the key priority for the budget review group in addressing budget scrutiny in the future? I know that we are moving slightly away from the subject of this evidence session, but I might as well ask you that question while I have the chance, because I might not get the chance again.

Professor Heald: The most important issue is the need to knock some sense into Westminster. This was going to be a difficult year anyway because of the new powers and because of Brexit, but we have also seen well-established procedures of the Scottish Parliament disrupted by what is happening at Westminster. There would be huge benefits for the House of Commons and scrutiny at Westminster if the budget process in the House of Commons was changed. If there is to be an autumn statement, it ought to be in September, which would be at least two months ahead of what we are going to have now.

I do not think that the UK Government has appreciated that the only way in which the very complex, asymmetric devolution that we have in the United Kingdom can be made to work is through collaboration between Governments on processes. They do not have to agree about policies but the system will not work unless they are willing to agree about certain standard operating processes.

If the UK Government does things at the last minute—for example, relating to the forthcoming tax year in the March budget—that have a knock-on effect on the finances of the Scottish Parliament, that will cause serious intergovernmental friction. We must not lose what we have already achieved. The budget process is being taken seriously, which sounds like a modest claim but, in the context of what happens at Westminster, it is quite a big achievement.

10:45

Professor Bell: I agree with David Heald. The Scottish Parliament can justifiably be proud of itself because of the extent to which it has differentiated itself from Westminster as far as scrutiny is concerned.

Thinking back to my time as an adviser, one of the issues was the point in the process at which the committee—or the Parliament or whatever—should try to influence the design of the Scottish Government's budget. Significant intervention once the budget has been laid out is probably not going to improve relations between the Government and the Parliament. It may be better if Parliament tries to introduce its influence at an earlier stage. Only on one occasion, when there was a minority Government, has such an intervention resulted in a small change in the budget during the period between September and the passing of the budget bill. The committee or the Parliament needs to find the point of leverage at which it could be most effective.

If we are starting to think about a more coherent system for designing tax policy in Scotland, there are many different points at which the Parliament might be willing to be involved. I think that my colleague Neil Warren spoke to the committee about differences in the approaches that are taken in New Zealand and Australia. None of those is perfect, but they are so radically different from what happens in the UK that I was quite surprised, when he described them to me, by the extent to which Parliament and the wider community are involved with the design issues. They are such a contrast to the current system that they are worth looking at.

The Convener: I have one last question in that area. How important is it that UK Treasury ministers are prepared to come in front of this committee to give evidence, given that we now have a shared power area in financial terms?

Professor Bell: This may be a good time for you to get the co-operation that David Heald talked about. The interchange may not be too antagonistic and the UK Government might be open to considering alternative ways of doing things.

Murdo Fraser (Mid Scotland and Fife) (Con): Professor Bell, your paper comments on the weakness in the growth of tax revenues, which you mentioned briefly in your introductory comments. Will you explain or speculate on why, when the UK economy is growing reasonably strongly, we are not seeing a consequent growth in tax revenues? Given the importance of the issue in relation to the block grant adjustment, is there any difference between the impact in Scotland and the impact in the UK as a whole?

Professor Bell: I have thought about that question but I have not had time to do any analysis as such. One thing that I have done a little bit of research on is the growth in self-employment. Part of the success story of the UK reducing its unemployment rate to 5 point something per cent since the recession has been a substantial increase in self-employment. Self-employment now accounts for about 13 per cent of total employment. It has increased more in absolute terms since the recession than has employment and it represents a huge part of the growth in overall employment.

The income of the self-employed is even more unequally distributed than that of the employed.

There are some very rich self-employed people who are employing people themselves—they have their own employees and companies—but there are also lots of self-employed people who are not employing anyone and who are relatively poor even compared with poor employees. That addition to the workforce is probably not paying any income tax at all. If they are paying any, they are probably paying it late because it will depend on when they complete their self-assessment. That is one possible explanation for what you describe.

It may also be the case that there has been some weakening of the growth in top salaries, which affects Scotland differentially. As I mentioned earlier, that is certainly the case in Aberdeen and Aberdeenshire. That has a disproportionate effect on overall income tax revenues, and it affects not just income tax revenues but, rather puzzlingly, VAT revenues, which have not grown as fast as expected, and national insurance revenues.

Income tax is the main culprit for the shortfall, but there has also been less-than-expected growth in revenue from VAT that I am at a loss to explain at a time when the savings ratio has never been lower. People are perhaps spending their money in areas where VAT does not apply, such as food, or on internet purchases, for which VAT is not always added in the same way, but I suspect that that is having only a small effect. It is an area that is worth exploring, because it is significant for Scotland if there is a difference in the lack of growth in income tax revenues.

Professor Heald: My recollection is that the recovery from the recession in many industrialised countries has not been particularly tax rich. I do not think that it is solely a UK issue. However, I do not have any insight into the difference between Scotland and England.

Murdo Fraser: I have a follow-up to that, which also follows on from Adam Tomkins's line of questioning on the Fraser of Allander report. Tax revenues are not growing as healthily as we might expect, the Scottish Government has by and large set its face against substantial tax increases under the powers that it has, we have a shrinking amount of money coming from Westminster, we have large areas of the public sector that are protected, and we have a whole range of new spending commitments, for example on childcare—how does all that add up?

The Convener: Silence. [*Laughter*.]

Murdo Fraser: Does it add up?

Professor Heald: I will not be tempted into giving political answers to political questions. Murdo Fraser is very clearly emphasising my earlier point that we are now seeing a build up of tensions. We had a long period of remarkably high public expenditure growth during the Labour Government's period in office, from about 2000 to 2007. That period was bound to come to an end, and it did so quite abruptly. After a period of public expenditure growth, you can probably accommodate a reduction somewhat, but when the reduction goes on for a long time—when growth stops or there is decline for a substantial period—tensions build up. The tensions are now building up, with pressures in sectors such as health and new spending commitments against the backcloth of stalling resources. How the budget is allocated is a political choice for the Parliament and the Government.

Professor Bell: A really interesting question around the autumn statement will be about which way the chancellor decides to go. Clearly, borrowing is about as cheap as it has been historically. Nevertheless, the UK budget deficit is about twice the European average. On the one hand, the chancellor is talking about no longer sticking to the 2019-20 timescale for running a budget surplus. On the other hand, we are not clear about when the chancellor wants to balance the budget or whether he is content to balance it in relation to current spending and is prepared to borrow for capital spending—for example, for infrastructure. The problem is that the pressures that are building up are around current spending—they are about the health, criminal justice and benefits systems and so on. The chancellor is in an interesting position.

Professor Heald: A matter that very much concerns me is that in a tight fiscal climate Governments find ways of doing things that do not get reported. One only has to open the newspapers to read about letters of comfort and guarantees being offered, and one wonders what the financial costs of those guarantees and letters of comfort will be at some future date. The Parliament should be watching carefully for non-conventional ways of getting things done, particularly if there is to be a financial sting later on.

The Convener: That is interesting. Ivan McKee has a supplementary question.

Ivan McKee (Glasgow Provan) (SNP): I understand from what David Bell wrote about the UK Government missing its deficit targets that that was largely a function of misforecasting income tax and other tax receipts. Such misforecasting is not new. If you look back to the recession, you can see that the percentage projection for income tax and national insurance receipts was way below where it was expected to be. That has been the main driver of the UK Government missing the numbers. In addition, over a number of years, George Osborne repeatedly missed the deficit targets.

My question relates to the fiscal framework and the block grant adjustment. The UK Government, which has been forecasting figures for hundreds of years, is unable to get anywhere near getting those numbers correct. We have now picked up a forecasting element—the Scottish Government will have to do that work and the Scottish Parliament will have to review it. The way in which the calculation works is that it is not just a question of our getting the forecast right but very much depends on the UK Government getting its forecast right, because there is a double impact from the outturn on the block grant adjustment. There is clearly the potential for a lot of issues to come up, but it is not only those matters that must be considered because there is a time lag, too. A lot of that stuff might not unravel for two, three or four years, given how the calculations are done. Will you comment on that? The borrowing powers are clearly the buffer to deal with that problem, but are they big enough to cope with what could be quite substantial swings between forecast and outturn?

Professor Bell: I take your point. The committee should invite Robert Chote to the Parliament to ask him what work the OBR is doing in relation to the shortfall in tax revenues, because the OBR is responsible for those forecasts, not the Treasury. I do not know whether the OBR has the resources to do that work but, presumably, a piece of work ought to be done between HMRC and the OBR to make the forecasts of tax revenues more accurate.

11:00

As far as the block grant adjustment is concerned, it is the relative movement in per capita income tax revenues that is significant. Unless there is a clear shock that affects Scotland or rUK and which does not have significant knock-on effects on the other, it is extremely difficult to be able to say that the relative position will change. Revenues in Scotland and rUK might be going down at the same rate, in which case the block grant adjustment is not really affected. It is clear that the oil shock affects Scotland in particular.

I did a quick calculation for some other work that I am doing on the welfare powers that are to be devolved over the next two or three years, in which I looked at the power in relation to disability living allowance, which is the biggest of the powers that is being transferred; I think that the budget is around £1.4 billion. From 2014-15 to 2015-16, if we apply the Barnett formula as opposed to looking at the actual claims for DLA, we find that the difference between them is £3 million in Scotland's favour—in other words, the impact is not huge. The borrowing powers are sufficient to deal with that order of relative movement, which is fairly minor.

It will be interesting to see the comparison between 2016-17 and 2017-18, which will be the first real test. At the moment, I do not think that I can say that the borrowing powers will be insufficient. I suspect that they will be of the correct order, but if there is a specific hit on, say, high earners in one part of the country relative to the other, we could be testing their limits.

Professor Heald: I would like to pick up on the issue of partial VAT assignment, which I think the Parliament should take very seriously. One ought to be able to get pretty good income tax numbers because of the way in which HMRC runs the income tax system, but the administrative system for VAT will not support a geographical breakdown, so the process must be done on the basis of survey data. The question will be, how good is that survey data? My understanding is that the surveys that would have to be used are quite small. Therefore, there is a serious issue to think about.

It will cause great political problems for the Government and the Parliament if, in three or four years' time, one gets big corrections to the block grant adjustment because of data changes, because it will incredibly difficult to explain to people why there is to be less health spending in a particular year as a result of something that happened three or four years previously. The Parliament should take seriously the issue of the quality of the data for the VAT assignment, and this is the time to start asking about that.

Professor Bell: I know a little bit about that. The Scottish Government pays to oversample some surveys, which means that we get a bigger sample in Scotland relative to its population size. That happens with the family resources survey, which is important for calculations on poverty, benefits and so on, but it does not happen with the expenditure on food survey, from which we are most likely to get good data on VAT and VAT payments. There, the sample size for Scotland is around 500. We do not want to be making a decision worth well over £1 billion based on that size of sample.

Ash Denham (Edinburgh Eastern) (SNP): I suppose that my question is more on the idea of reality versus perception in relation to the short-term impacts that we have seen following the announcement of Brexit.

I am sure that everyone has seen the recent headlines crowing that the predictions of economic meltdown have not come to pass, and how marvellous it is that that has not happened.

This week, I visited a small food manufacturer and talked to the people there about how things were going for them, as they do a bit of exporting. They said that they were already seeing their input prices going up but that there was severe pressure on them from retailers not to raise prices. As a small Scottish manufacturer, they felt that they were between a rock and a hard place. It seems that this could be a really challenging time for Scottish business.

Professor Bell: I think that it will be quite difficult, Clearly, when prices are volatile, the circumstances for businesses are more difficult than when prices are stable. It is true that we have a relatively small number of major retailers in this country, and they have considerable power over their suppliers. None of them wants to be seen to be increasing prices, because that attracts a lot of negative publicity, and the result is that pressure is put on the small suppliers. That is unwelcome. However, as I said earlier, financial markets just move more quickly than goods and services markets. The financial market eventually puts pressure—in this case, because of a depreciation leading to higher prices—on the production of real goods and services. That is how the effects will emerge over time. Those on the other side—the consumers—will then find that things are more difficult. If prices go up, they will find that goods in the shops are more expensive, so their budget will not go as far as it used to go. The economy will then shrink as a result and, unfortunately, because of that instability both consumers and, to some extent, producers will be negatively affected.

Ash Denham: The sharp drop in sterling does not seem to have captured commentators' imagination much, yet it could be leading to quite significant impacts. This week, it was suggested that any more announcements from the UK Government about a hard Brexit could lead sterling to drop even further. Presumably, that would also lead to more impacts over the short and medium term.

Professor Bell: The correct interpretation—and Paul Johnson of the IFS said this soon after the depreciation—is that we are all poorer. It is not a good-news story. It changes the distribution of the work that we do in the country: more of us are working for foreigners and supplying them with goods, which does not improve our standard of living at all. Nevertheless, a lot of commentators seem to treat it as wholly a good-news story, which I find puzzling.

Professor Heald: A lot of the commentary assumes that there is no import content in what the UK exports.

The Convener: I think that Willie Coffey has a question on the same area.

Willie Coffey (Kilmarnock and Irvine Valley) (SNP): Yes. Thank you, convener. To follow up on Ash Denham's point, I know of an Ayrshire electronics company that imports components mainly from China as part of its production process. It reports that its costs have gone up by about 13 per cent this year. Realistically, is there anything that the UK Government can do, or that the Chancellor of the Exchequer can do when he resets the economy in a few weeks, to help such companies throughout the UK?

Professor Bell: There is not that much that the chancellor can do; there is possibly more power in Mark Carney's hands. Yesterday, we saw the pound recover a bit after Mark Carney gave some assurance that he was going to stay in post. It seems odd for the financial markets to respond in that way.

Clearly, if the UK increased interest rates, it would make sterling a more attractive currency than it has been recently—that might push it back up again. However, costs would be associated with that, with businesses with loans, home owners with mortgages and so on exposed to higher interest rate charges. It would be the most effective way of increasing the value of sterling again, but, as you will see, you are almost between a rock and a hard place because of the benefits and costs associated with the action that Mark Carney might take. To be honest, I think that we are probably going to continue with low interest rates for some considerable time.

Willie Coffey: Do you have anything to add, Professor Heald? Can you shake some more sense into this?

Professor Heald: I think that we are now coming into a period of testing the division between fiscal and monetary policy. For a long time now, my personal view has been that monetary policy has been too lax and fiscal policy too tight, although that is not easy to manage when you have established an independent Bank of England and independent monetary policy. There have been times over the past week that have resembled the chairman of a football club giving the manager a vote of confidence. We are in a strange period with regard to the independence of the central bank, but there is unquestionably an issue with the balance between monetary and fiscal policy.

The Convener: There are two supplementaries, one from Neil Bibby and the other from Maree Todd.

Neil Bibby (West Scotland) (Lab): Obviously the witnesses do not think that interest rates will be increased, but what would be the budgetary impact of an increase? Would there be any Scotland-specific impact?

Professor Bell: It would make pensions more affordable. It could also increase the cost of incremental Government borrowing, but we do not know that for certain. At the moment, Government borrowing costs are extremely low, but it is difficult to say whether a rate rise would increase them. Otherwise, I do not think that there would be any massive effects.

Professor Heald: I cannot remember a time when I had so little sense of the direction of UK fiscal policy. Depending on when you read the newspapers—and depending on which newspapers you read—we will on 23 November see a fiscal tightening or a fiscal loosening. My hunch is that there will not be very much of anything, because although the UK can borrow very cheaply, the fall in sterling is giving a very bad signal. The problem with a falling exchange rate, even if you think that it might help deal with your balance of trade problems, is that once your currency starts to fall, it is not necessarily easy for you to put a floor under it where you want that floor to go. There are significant constraints on what the chancellor can do on 23 November and my hunch is that, net-wise, he will not be able to do very much.

Maree Todd: My supplementary question is about the decline in sterling. You have made it pretty clear that the most negative effect will be on the living standards of poor people. Do you have any thoughts about strategies that could be employed in the UK budget or in Scottish plans to mitigate that effect?

11:15

Professor Bell: The national living wage will have a positive effect—evidence of that is already coming through the earnings data. It helps those who are in a job, and we have pretty high employment rates. However, it does not help the self-employed, because they do not have to pay themselves the national living wage.

The effects of the national living wage are spread across the income distribution—they are not focused just on the poorest members of society, although we might think that they would be. Many people who earn the national living wage are in households where someone earns a lot more, which means that the benefit might go to a household in the middle or even towards the top of the income distribution. It has helped a bit.

There is some momentum behind this. The further cutting of benefits to working-age families will make the situation worse. One form of mitigation might be not to go ahead with further benefit cuts.

Patrick Harvie (Glasgow) (Green): Good morning. Since I joined the committee, I have been reminded of the saying, “The more I see, the more I see there is to see.” Today’s meeting has very much put me in mind of that.

I will ask about public sector pay, but first I will pick up on the tax discussions that we had earlier. There was discussion about the danger of potential overexpectation about what devolved tax powers can do and about the tension between the argument for a bolder, more radical approach and the pragmatic desire to be slow and incremental. I ask you not to endorse a political direction—for example, I have always argued that someone who is on my level of income can afford to pay more tax—but to explore what is possible within the Scottish budget.

One way of making an incremental change in the direction of a more radical end point is to split the basic rate in two and freeze or relatively affordably reduce the rate for people who are on a below-average income, which would allow people who are on an average income to pay a little more and only people on a significantly higher-than-average income to pay significantly more, without harming those who are on a lower-than-average income. That is surely an affordable option within the powers that the Scottish Parliament and Government have, because it would cost relatively little to reduce tax for those who pay very little tax and would generate more from those who earn more. Is that correct?

Professor Bell: That is possible. The question is to what extent it would result in the outcomes that you desire. Changing the tax band for 1,000 people could cause them to pay £100 a year more if we did just straight accounting, but would that generate £100,000 in extra revenue? That is the question. A bit of work would need to be done on that.

The issue is how people might respond. We know bits and pieces, but we do not know enough about Scotland to understand that. People can react in various ways. They could try to maintain their real income by working more hours—they would pay more tax but, by working more, they would generate the same after-tax income as they had before. That is one possible reaction.

Other reactions could be reducing hours, retiring earlier or leaving work. For some people, those alternative opportunities are not there—for example, the young do not tend to retire early, and some people do not have the opportunity to change their hours without completely changing their contracts.

What you propose is certainly not impossible, but it is important to identify what the reaction would be. If you thought that you were going to raise £100,000 but you raised only £80,000, would the change still be worth doing? Perhaps it would be, but you would need to get a feel for that.

Patrick Harvie: Is it fair to say that we would get a feel for that only by putting a toe in the water?

Professor Heald: First, you ought to get the Institute for Fiscal Studies to do fiscal modelling. As Scotland has a policy choice, there will be much more discussion of such issues. I made the point that I am sympathetic to the argument that the jump from 20 to 40 per cent is too steep. I have thought that for a long time. When the Liberal Democrats wanted to put the 40 per cent rate up to 50 per cent during the Labour Government, I was against that, and I still broadly hold that position.

The problem at the top end is more one of enforcement. One of the worrying things about income tax and other taxes on high incomes is that we run the danger of the perception that taxes are not paid by such people, even though the data shows that a lot of income tax revenue comes from high earners. If we create a sense among the public that the very rich do not pay income tax, we could get into the same problems as we have with inheritance tax, whereby a lot of people worry about it even though their inheritance tax liability is negligible or zero. That is aggravated by the sense that, if people are rich enough, they can avoid inheritance tax. At the top end, one should think carefully about enforcement issues, rather than the rates.

Professor Bell: To add to David Heald's point there and to a point that he made earlier, the committee should remember that national insurance is in effect another income tax and it would not necessarily change. Members have to think about the income tax rate and the national insurance rate in combination, rather than on their own.

Patrick Harvie: In addition to the points about income tax at the top end, we need a discussion about wealth taxes, as wealth is an even greater source of inequality. Perhaps that is for another day.

Let us assume either that we get an autumn statement from the UK Government that leads to some fiscal loosening or tax changes that benefit the Scottish budget in the short term or that the Scottish Government wants to—as I suggested—put a toe in the water and see what it can do with devolved tax powers. Let us assume that there is some capacity from one source or another. The real-terms value of public sector pay has been substantially eroded since the late 2000s. Is it reasonable to suggest that, if we want any opportunity to recoup or restore some of the lost value in that pay, that should be done before inflation returns to significant levels, as is expected? Is now the time to do it, rather than waiting until after inflation has risen again?

Professor Heald: I understand where your argument comes from, but one reason why the economy did much better in terms of employment during the fiscal consolidation period was that public sector pay was held down. There is a trade-off in the public sector between the number of jobs and pay rises. The fact that public sector pay went down protected a substantial number of jobs in the aggregate.

As was said earlier in the Brexit discussion, the country is now worse off economically than it was before. It is extremely doubtful that we could have an abrupt increase in pay levels that would take us back to where we were. There will always be some trade-off between the amount of employment and pay rates. Public sector pay cannot get too far out of line with private sector pay without that damaging recruitment, morale and retention. However, this is not a time for big increases in public sector pay.

Patrick Harvie: I was suggesting not necessarily a single, big-bang restoration back to the position in 2007-08 but beginning to recoup some of the lost value. There might be two reasons why the trade-off between retaining the level of employment in the public sector and public sector pay was stronger at the start of the process than it is now. One reason is not just that we have the taxation powers to make a different choice but that, under the new settlement, public sector pay increases in Scotland would mean increased income tax payments from employees, which would have the consequence of a reduction in the block grant in the future. The second reason is that labour-intensive public spending does not suffer from the problem that was identified earlier of imports being more expensive. Do those two factors make public sector employment better value for money now than previously?

Professor Bell: I agree with your point about import content. There are certainly public services that will see no rise in costs because no import content is involved in their activities.

I do not know the answer on the overall increase in income tax revenues. About 23 per cent of employment in Scotland is in the public sector and, on average, those public sector workers have higher pay than private sector workers—I am not sure what the margin is at the moment. However, that does not mean that public sector employees make bigger contributions to income tax. The amount of tax that a few very highly paid private sector workers pay can dwarf that paid by a large number of public sector workers whose wages are close to or just above the personal allowance tax figure.

Maybe at the back of what you are saying is the issue, particularly in England, of public sector pay getting so low that there are problems of recruitment, morale and retention. If we get those aspects wrong for a short time, the negative effects can be long lasting. I noted earlier this week, for example, that the Universities and Colleges Admissions Service has seen a 10 per cent reduction in the number of students who wish to become medical students, which is a signal that young people think that going into medicine is not as good a prospect as it used to be.

I do not necessarily agree with everything that you said, but I do think that there might be an issue for the committee to look into. A huge proportion of the budget is spent on wages and salaries, but the question is whether that spend is effective in getting people into public services who are motivated and willing to provide the kind of service that the public want.

Professor Heald: We might get some money back in income tax revenues but, given that people's gross pay will probably not be high and given that they make national insurance contributions and occupational pension contributions, the feedback from tax will be much less than the gross expenditure.

11:30

Professor Bell: I should add that the public sector pensions issue is extremely important and has not been visited since Audit Scotland did a review about five years ago. Some of the pensions sit in the Scottish budget and are subject to pretty severe pressures that may impinge on other parts of that budget. I wrote something about that recently that I would be happy to share. The component of the Scottish budget that goes on public sector pensions could expand over time and perhaps the committee should look at that.

Patrick Harvie: My last question is on a separate issue, which I flag up as something that we might look at in the future. The UK Government has placed a lot of political emphasis on public sector debt at the UK Government level. Has either of you looked at whether the level of debt that local authorities hold is sustainable and affordable?

Professor Heald: Local authority debt comes within UK debt—it is in the numbers that the Office for National Statistics puts out. I have done no work on local government debt.

Patrick Harvie: I am thinking about the finances of our local authorities, which deliver services. Those services will be squeezed. Will the cost of the debts that they hold be a growing and significant factor in their finances?

Professor Heald: I expect so, but I have no information on that.

Professor Bell: Neither do I.

The one thing that I will add is that the UK produces whole-of-Government accounts each year, which go beyond the national debt. In effect, that is the payments that the UK Government has to make to meet its current liabilities. Other contingent and future liabilities are included in the whole-of-Government accounts that Scotland is to some extent also exposed to.

I mentioned public sector pensions, which are currently not strictly part of the accounting but will evolve over time. There is also the national rail debt. A few things are not on the balance sheet and there is a strong case for not panicking about them but monitoring them.

The Convener: I thought that I was in "Dad's Army" for a moment.

You have given us a good understanding of some of the key economic and fiscal challenges that we face. In summing up, can you tell us briefly what the medium-term prospects for the Scottish economy are?

Professor Bell: We are entering a somewhat difficult and uncertain period. The sources of growth are not obvious. The Brexit debate has yet to play out, so we do not know how much our trading relationships will change. We are perhaps a little less exposed to that than the rest of the UK is, because our exports to the rest of the UK have been growing much faster than our exports to the rest of the European Union over time.

However, it seems to me that we are not entering a phase where the economy—and, alongside that, tax revenues—will grow rapidly. Even though the economy is growing okay, we have already discussed the issue that tax revenues are not growing as fast as might have been expected had past patterns been replicated.

I suspect that we are in for a difficult period where hard choices will have to be made. It is not obvious how we can get out of that situation.

Professor Heald: I agree with that.

The Convener: James Johnston just whispered in my ear that the discussion reminds him of the scene from "Jaws" when the sheriff sees Jaws coming towards him and says,

"You're gonna need a bigger boat".

Thank you very much for coming along. The process has been fascinating and you have unearthed quite a lot of issues that we will have to consider. Pulling together all the aspects that you have drawn to our attention will be an interesting challenge for us, but thank you very much for coming along.

11:35

Meeting continued in private until 11:54.

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