OFFICIAL REPORT
AITHISG OIFIGEIL

Finance and Constitution Committee

Wednesday 27 September 2017

Session 5

The Scottish Parliament
Pàrlamaid na h-Alba

Wednesday 27 September 2017

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FINANCE AND CONSTITUTION COMMITTEE
22nd Meeting 2017, Session 5

CONVENER

*Bruce Crawford (Stirling) (SNP)

DEPUTY CONVENER

*Adam Tomkins (Glasgow) (Con)

COMMITTEE MEMBERS

*Neil Bibby (West Scotland) (Lab)
*Alexander Burnett (Aberdeenshire West) (Con)
*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)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Professor David Bell (Royal Society of Edinburgh)
Professor David Heald (University of Glasgow)
Paul Johnson (Institute for Fiscal Studies)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Finance and Constitution Committee

Wednesday 27 September 2017

[The Convener opened the meeting at 09:30]

United Kingdom Public Finances (Outlook)

The Convener (Bruce Crawford): Good morning and welcome to the 22nd meeting in 2017 of the Finance and Constitution Committee. It is the usual story as far as mobile phones are concerned, folks.

The first item on our agenda is evidence from Paul Johnson, director of the Institute for Fiscal Studies, on the outlook for the United Kingdom public finances. Welcome to the meeting. I am very grateful to you for being here, and thank you for providing your slides in advance.

Are there any particular opening lines that you would like to give us?

Paul Johnson (Institute for Fiscal Studies): I will briefly remind the committee of the background on public finances. We have now had seven years of pretty tight spending control following the financial crisis and the very big deficit that we had back in 2010. The deficit is now down to less than 3 per cent of national income, which is a big change from seven years ago, but that has come at a cost of some historically unprecedented levels of spending cuts across much of the public services.

Looking forward, on current policy, the expectation is that the deficit will get down to 1 per cent of national income by the end of the decade, against the chancellor's self-imposed target of 2 per cent. It looks like he has a bit of wriggle room. However, we also have an unprecedented level of uncertainty about what might happen to the economy over the next two or three years given how little we know about the shape of any Brexit deal and how that might play out.

The chancellor has quite a lot of difficult decisions to make at the moment: how much use, if any, to make of his fiscal room for manoeuvre; how much to worry about the debt, which is now well over 80 per cent of national income; and how seriously to take his target to get to budget balance in the mid-2020s. All that is against the background of very poor productivity performance and very low increases in living standards—indeed, following recent inflation, we probably have falling living standards again over this year. So there are lots of issues on the spending and public finance side.

Then there are some issues on the tax side. In particular, I am sure that the chancellor would like to bring back his proposals to bring taxation of self-employment and employment more into line, which did not get through in the previous budget. However, my guess is that the parliamentary arithmetic will make that even more difficult than it was earlier in the year.

The Convener: Thank you for that. Murdo Fraser has some questions on borrowing, the Office for Budget Responsibility forecasts and fiscal policy.

Murdo Fraser (Mid Scotland and Fife) (Con): Good morning, Mr Johnson. I want to pick up the point that you made about the chancellor's wriggle room in terms of any policy choices that he might make. The OBR's latest forecast, which is from March, suggested that the chancellor was on course to meet his borrowing target with some room to spare. Do you think that the economic and fiscal outlook has changed in any way since March? If so, what does that mean for the chancellor's choices, coming up to the budget?

Paul Johnson: My guess is that the economic outlook will not have changed very much in the OBR's view. The economic news this year has not been terribly different from what might have been expected.

As I said in my opening statement, the overwhelming factor is the uncertainty about where the economy might go over the next three or four years. It looks like there is quite a lot of room for manoeuvre up to 2020. However, even given that £20 billion or so of apparent room for manoeuvre, as the OBR also said, there is something like at least a one-in-three chance—I cannot remember the number—that, under current policy, we would still breach the 2 per cent target because the economy may well end up doing less well or tax receipts may well end up coming in less strongly than expected. That probability is just based on historical mistakes in forecasting.

As I said, the chances are that the uncertainty in either direction is greater than normal this time round, so there may actually be a more than one-in-three chance that the target will be breached because of the higher level of uncertainty.

That is the balancing act that the chancellor has to perform. He has to decide how much weight to give to strongly bad outcomes in three or four years and how much to give to the central forecast. If he gives a lot of weight to the central forecast, he may feel that he has more room for manoeuvre than if he puts a lot of weight on the uncertainty.

Murdo Fraser: In the light of what you have said, how likely do you think it is that the chancellor will, in the budget, announce some loosening of fiscal policy, or will he just want to keep the ship sailing in the same direction?

Paul Johnson: I would not want to put a probability on it. As I said, the chancellor is weighing up two things. On one side, there is uncertainty and the need, potentially, to keep some fiscal firepower back for what may turn out to be bad news on whatever the Brexit deal turns out to be. On the other side, he has apparent room for manoeuvre, and there are clear pressures on public services. A couple of years ago, one could reasonably have said that all the public spending cuts had not really started to push through into very obvious problems with public services, but it is much harder to make that case now.

You may remember that, last autumn, the chancellor found more money for prisons because it was clear that there were big issues in prisons at the time. Back in March, he found more money, partly through an increase in council tax, for social care in England. This time round, it is pretty clear that social care is still an issue; waiting lists in the national health service are growing and so on; and local government is beginning to show significant signs of strain. In addition, the big cuts in welfare benefits are really just starting. There is quite a lot of pressure on the chancellor, therefore, to find a bit of money for those public services. He will have to find a balance between leaving himself some room for manoeuvre later on and responding to some of those pressures, including public pay pressures. My guess is that, if his position is going to move anywhere, it will move towards a loosening, but I do not know how big a loosening that will be.

Willie Coffey (Kilmarnock and Irvine Valley) (SNP): I want to talk about the potential room for manoeuvre. In your paper, you speculate that there could be a further £3.5 billion budget cut by the UK Government. Does the room for manoeuvre assume that that is going to take place or that it might not happen?

Paul Johnson: There is a set of spending plans laid out in the budget that includes some significant increases in investment spending and, relative to national income at least, some pretty significant reductions in day-to-day spending. The plan is to get from a 2 per cent—well, nearly 3 per cent—deficit to a 1 per cent deficit, which is a tightening; there will be a fall in the size of state intervention over that time.

That goes back to the choice that we were just describing. The chancellor could decide that he is happy with the deficit roughly where it is, at 2.5 to 3 per cent of national income. That gives him a lot of room for manoeuvre, and the debt could probably bear a few years of 2.5 to 3 per cent deficits. That path would be very different from the one that he is currently planning, which is to get the deficit down to 1 per cent. That is the big choice that he is going to have to make.

Willie Coffey: What proportion of that £3.5 billion cut might impact on the Scottish budget?

Paul Johnson: I am afraid that I do not know exactly what the Barnett consequentials of that would be.

Willie Coffey: The OBR said that, even though the economy has been poor for 10 years, there is no capacity in it to expand. It also said that the economy therefore cannot rely on above-normal levels of growth to help to bring the deficit down further. Does that edge us more towards more cuts being the only solution to bring us back into line?

Paul Johnson: In a sense, the OBR has drawn a desperately depressing conclusion. We have had seven years of very poor growth, and in terms of national income per head we are barely above where we were back in 2008—we have had a decade with essentially no growth in national income per head. The UK economy is something like £300 billion smaller than we might reasonably have expected back in 2008 on the basis of historical trends, and yet the OBR judges that there is no room for growth because we are basically at the new trend.

If the OBR is right, that means that there is little scope for a fiscal expansion, in a Keynesian sense, to drive additional growth, for example, because we are at capacity. It also means that, in the long run, additional spending will have to be paid for through additional tax, because there is no scope for above-trend growth. That is very different from the situation that we might have been in a few years ago, when we had a big deficit, poor growth and at least the general acceptance that the economy was not at trend. If it is right that we are at trend, that creates a much bigger constraint on Government.

Adam Tomkins (Glasgow) (Con): You caveated all that by saying, “If the OBR is right.” What is your professional judgment as to whether the OBR is correct in its assumptions?

Paul Johnson: It is an incredibly difficult judgment. The Bank of England is in a reasonably similar place, and there is a wide range of views among the macro forecasting community—of which, happily, I am not a part.

Employment levels are one of the key inputs in the OBR calculations, and it is hard to believe that there is a lot of scope for additional employment as we are at record levels. The flip side is that we have poor levels of productivity and earnings growth; part of the judgment is that that has all been lost—there is no additional scope there. Investment has not been strong in recent years, which has reduced capacity. The OBR numbers are also partly down to immigration: if that falls off a bit, that also reduces scope for economic growth.

I do not know whether the OBR is dead right. There may be a little bit of spare capacity, but I do not think that many people believe that there is a lot of the spare capacity that would allow for big differences in terms of judgments.

The Convener: I have a couple of supplementary questions. You mentioned migration, and discussions are going on around Brexit and European Union nationals. Would you expand on the room for growth in our economy, given the challenge that we will have with regard to the number of people who will be in our pool of EU nationals?

Paul Johnson: There are a number of parts to that.

First, there is a lot of uncertainty about what Brexit might do to levels of immigration. The OBR's judgment is that net migration will fall significantly, which will hit the public finances reasonably hard. Its view is that tax revenues will be down by about £6 billion, relative to what they would have been. If the Government gets to its stated target of reducing net migration to below 100,000, there would be an additional £6 billion hit to the public finances through lower tax revenues. The unknown is the scale of potential return movement by European workers. The UK economy looks very different from what it would have looked like had we not had the net influx of about two million European workers over the past decade and a half.

It is important to distinguish two things. One is that net immigration may go down, which would have a relatively gradual effect on the economy. Another possibility is that large numbers of people may decide to leave, so we may get net emigration—at least of some classes of workers and nationalities. That would make certain parts of the economy very difficult to maintain and, in the longer run, may change the structure of the economy.

09:45

The Convener: That was brought alive to me this week when I spoke to people at a construction company in my constituency who are already beginning to see some haemorrhaging of people from the United Kingdom, so they are—rightly—taking an aggressive approach to the recruitment of apprentices to insure themselves for the future. If that construction company is going out there and aggressively recruiting and other people in the construction industry react in the same way, that might leave parts of the public sector vulnerable. It is not in the nature of the beast of the public sector to respond in the same way, so where is it going to get its people from in the future?

When I heard that what that company was saying, I became worried about how the public and private sectors respond to the issue. I am not criticising the people at that company, because they are doing the right thing for themselves, but do you think that there is a potential problem for the balance of the economy and there being enough people to work in these areas in future?

Paul Johnson: There are different parts of the economy—some bits of agriculture, for example—where, historically, the UK has been dependent on migrant labour to do a large fraction of the work. In a world in which that labour is simply not available, my guess is that some of that business will just stop. If, for example, we cannot get people to pick our strawberries at an appropriate wage, we will have made a decision that it is better that our economy does not support that kind of work.

What you said about the construction industry taking on apprentices is interesting. It is very hard to find any economic research that suggests that net migration has had the impact of reducing opportunities for training and higher wages among the native born, but the way in which a lot of that research is done makes it quite difficult to be confident about that when there has been such a big change over a prolonged period. It is at least possible that one effect will be to increase the training opportunities that are available to British-born workers. The economic research does not show that, but it seems to me that it is possible. On the other hand, it is very clear that the total number of jobs that are available will not increase.

There are hot spots in the public sector. Nursing in London and the south-east, for example, has a very high proportion of European and other foreign-born staff, and it is clear that there has already been an effect there. It takes quite a long time to train some groups of workers. That said, despite the end of the nursing bursary, there is still an overdemand for training places at university, but it will cost us more to train more nurses.

Ivan McKee (Glasgow Provan) (SNP): I want to explore immigration numbers. It was interesting to hear what you said about the £6 billion that is already baked in. What assumption does that place on where net immigration would be? Do you know that number?

Paul Johnson: I do not know the number. That is based on the difference between the numbers coming in over the next three or four years and what the OBR would have expected had we not had the Brexit vote. Off the top of my head, I do not know the precise numbers.

Ivan McKee: The number has been around 300,000 up to now.

Paul Johnson: Yes. That is the gross figure.

Ivan McKee: There will be another £6 billion hit to the tax take if it drops below 100,000.

Paul Johnson: Yes.

Ivan McKee: Right. So the OBR assumes that that number will be somewhere between 100,000 and 300,000 in future.

Anecdotally, having talked to eastern Europeans here and in eastern Europe, I think that there is quite large potential for net emigration, accelerated by the exchange rate situation that makes it far less attractive for people to work here and send money home as they can earn more by working in another EU country. That has not been factored in at all, and there has been some recent data suggesting that we are starting to move to a net emigration situation with some eastern European countries. Do you have any assessment of where we would be if there was a further hit to immigration and we started to see significant net emigration back to eastern Europe?

Paul Johnson: You are exactly right about what might happen and what is driving it. The thing that will make the 100,000-or-less target attainable is us just making this a very unattractive place for people to come to live and work in, irrespective of any policies that we pursue. There may be a tipping point at which things start to change very quickly. We are not there yet—we still have significant net immigration—but if we are losing £6 billion now and we will lose another £6 billion if we get below 100,000, we would clearly lose at least that much again in tax receipts if we got to a point of net emigration.

It is also important to think about the composition of the population. Net figures can be misleading. If, given uncertainty about their rights, a lot of British pensioners who currently live in the rest of Europe came back, the net number might not go down so much but we would swap working-age people who pay tax for pension-age people who are in receipt of benefits.

Ivan McKee: That is clear. You talk about us losing £6 billion, another £6 billion and perhaps another £6 billion. That would have a material impact on the deficit and the debt as a percentage of gross domestic product. I think that £15 billion is close to 1 per cent of GDP.

Paul Johnson: Yes, 1 per cent is about £18 billion, so that would have a significant impact. Previous OBR reports show that the public finances have been helped by immigration coming in above expectations. That has dug the chancellor out of a hole once or twice in the past six or seven years. So yes, it does add up.

We have been looking at the gross impact on tax receipts as a whole, but it is worth looking at the other side of the issue. There are clearly areas where the impact on public services—local health or education services—goes in the other direction. That impact tends to be very concentrated, whereas the tax receipts are beneficial across the piece. Arguably, the way that local government has been funded in the past seven or eight years, particularly in England, has not compensated adequately for increased population.

Ivan McKee: The scenario is clearly different in Scotland, where net immigration has traditionally been lower, so the impact might be much bigger. Have you assessed the impact that reduced immigration across the UK would have on the UK's growth rate?

Paul Johnson: As a first approximation, the evidence suggests that reduced immigration would have no effect on the growth rate per capita—the evidence does not particularly show that having more immigration has a big impact on the growth rate per person—but the effect on the overall growth rate would be essentially proportional to the reduction in the population. If the population were 1 per cent smaller, the economy would be 1 per cent smaller.

The Convener: Adam Tomkins wants some clarity on the £6 billion figure.

Adam Tomkins: I know that it is not your figure—it is the OBR's figure—but is the £6 billion a loss to the economy of £6 billion every year?

Paul Johnson: It is a loss to tax revenues of £6 billion a year by, I think, 2020 or 2021. It is the cumulative effect of having fewer people. The calculation is that, if fewer people come in this year, next year, the year after and the year after that, the revenue that comes to the Exchequer will be £6 billion less in 2021 than it would have been had net immigration continued at its previous level.

Adam Tomkins: I think that you just said in response to Mr McKee that the figure reflects only lost revenue and does not take into account reduced expenditure on public services in areas of high immigration.

Paul Johnson: That is correct.

Adam Tomkins: Is there a figure that combines those two things, so that we have a complete picture rather than just one side of the coin?

Paul Johnson: There are two ways of answering that. One is that, as I said, public spending has tended not to reflect the increase in people, so there is not a direct one-to-one correlation. That has probably been one of the problems—the way in which local government has been financed, particularly in England, has not reflected increases in people.

That would leave spending per person higher than it otherwise would have been, but whether there would be much effect on total spending is more questionable. For example, benefits spending, which is directly linked to individuals, is very low for immigrants. Clearly, there is more spending on health and education. It is some fraction of the £6 billion—it is less than £6 billion. It is probably a couple of billion pounds, but that is a bit of a guess.

The Convener: Forgive this brain for needing a wee bit more information on the £6 billion. I assume that, over the financial years until 2021, the figure will go from something like £4 billion to £5 billion to £6 billion—it will not be those exact numbers—and then, after 2021, it might go up or down from £6 billion.

Paul Johnson: The figure is always against a counterfactual, and I suppose that one issue is whether it is reasonable to think that there is a counterfactual in which net immigration remains at the high level that it has been at in the past. If the counterfactual is that we have net immigration of 300,000 a year ad infinitum, it might be reasonable to ask whether that is sensible and whether the figure would have to have tailed off in any case.

Maree Todd (Highlands and Islands) (SNP): I know that there is a general challenge on the public purse because of inflation, but is there a specific challenge because of the sterling crash? Anecdotally, I am told that, when the national health service buys a magnetic resonance imaging scanner, it often does so in a different currency. Is what is happening with sterling having a specific impact on public spending?

Paul Johnson: I am afraid that I do not know the details of NHS spending in that sense. However, if you are buying big things from foreign providers—I think that the Ministry of Defence does quite a lot of that—the currency will have a big impact on the prices that you pay. I suspect that the biggest impact is on public sector workers. A 1 per cent cap might be manageable if inflation was at 1 or 2 per cent but, if inflation was at 3 or 4 per cent because of the devaluation, that would be harder to manage. We spend £180 billion a year on public sector pay, so an extra 1 or 2 per cent on that probably dwarfs any of the other impacts.

The Convener: Given that we are on external factors and single market issues, we will come to Ash Denham next. Because Paul Johnson has introduced the public sector pay issue, we will come to Neil Bibby after that.

Ash Denham (Edinburgh Eastern) (SNP): I saw your tweet on Twitter—I will read it out to you. You said that you were

“stunned both main parties support leaving the single market. This guarantees to make living standards worse”.

Will you expand on that?

Paul Johnson: I am sure that I did not tweet the word “stunned”.

Ash Denham: You did.

The Convener: Unless you have a parody account somewhere.

Paul Johnson: It is clear that leaving the single market will reduce living standards relative to a world in which we stay in the single market. In a sense, that is a simple proposition. The European Union is by far our biggest, closest and richest trading partner. We do about half our trade with it and, if we make that trade more expensive, that will on average make us worse off.

The single market is particularly important for the service industries, because it is through the single market that they have pretty free access to the rest of the EU. Very few free-trade agreements, if any, provide anything like the kind of integration that the single market gives for service industries. The customs union is more crucial for manufacturing, where border checks and non-tariff barriers create the biggest issue. Making that trade more difficult will make us worse off.

The depreciation in sterling was partly about an expectation that the situation would become more difficult and that UK goods and services abroad would become more expensive. My guess is that, if we end up with a bad trade deal, sterling will go down again, partly in compensation for that expectation. As we know, the first impact of that is an increase in prices, which makes us worse off.

Ash Denham: What impact would leaving the single market and, possibly, the customs union, have on the UK’s public finances? What would be the knock-on effect on Scotland?

10:00

Paul Johnson: The OBR has made some fairly modest assumptions about the impact of leaving the EU on the economy and, therefore, on the public finances. The suggestion is that it would make a difference of something like £20 billion to the public finances in the early 2020s.

Ash Denham: Is that for the UK or for Scotland?

Paul Johnson: The UK.

I will take this in three chunks. The first issue is that, in the public finances, we spend about £15 billion a year on EU membership—that is the gross figure; it is about £8 billion net. The difference with regard to the £8 billion net that we spend has not been allocated in the public finance numbers, which means that, relative to the current baseline, there is an extra £8 billion to spend. However, the OBR numbers suggest an overall loss to the public finances because of lower growth. Relative to the status quo ante, there is something like minus £8 billion to spend—I am afraid that I do not remember the precise numbers.

The second issue is the so-called divorce settlement. I do not know what number that will involve, but it sounds as if it will be somewhere between £20 billion and £50 billion. That will be a big number, but one should think of it as a one-off number, which will increase the debt but not increase the deficit each year. In that sense, it is a much smaller number than £10 billion a year, which will accumulate to an awful lot over a long period.

The third issue concerns not just what the public finance impact will be in year 1 but what the impact on economic growth in the UK will be each year after that. Even if leaving the EU has an effect of only 0.1 per cent a year, that dwarfs all the other numbers because, within 20 years, that adds up to a large number. The work that has been done at the London School of Economics and the University of Warwick suggests that the UK economy would be about 5 to 10 per cent smaller after 20 or 30 years than it would have been if we had stayed in the single market. An economy that is 5 or 10 per cent smaller is much poorer in terms of its capacity to manage the public finances.

Ash Denham: You have said that leaving the EU is guaranteed to make living standards worse. Can you put a percentage on that? You have said that the economy could be 5 to 10 per cent smaller. Could living standards therefore be 5 to 10 per cent worse?

Paul Johnson: If that was the effect on the economy, that would be the effect, on average, on living standards. I think that there is genuinely no uncertainty about the direction of the impact, but the scale of the impact is difficult to know.

Neil Bibby (West Scotland) (Lab): The percentage of workers who are in the public sector is higher in Scotland than it is in the rest of the UK—it is about 21 per cent in Scotland and 17 per cent across the UK. If the UK Government were to relax the public sector pay cap, what would be the impact on departmental spend and on the Scottish budget? Would it be fair to say that lifting the pay cap across the UK would disproportionately benefit Scotland and the Scottish budget, because of the higher number of public sector workers in Scotland?

Paul Johnson: The big question is what the Chancellor of the Exchequer means by lifting the public sector pay cap. As we have seen in relation to the recent announcements on the police and prison officers, it could be said that we are going to pay them more but without giving the services more money. That would not flow across into the Scottish budget at all, because the same amount of money would be going in.

You could imagine the chancellor saying in the budget that he will no longer ask pay review bodies to keep within a 1 per cent cap and that he will take note of their recommendations. It is interesting to see the attitude of the NHS Pay Review Body this year to the 1 per cent pay cap. In the introduction to its report it says, starkly, that because it has to take account of how much pay should rise in the context of all the pressures on the NHS, it had to think hard about whether to recommend a zero increase, because it was a pretty fine judgment as to whether the £1.5 billion—or whatever it would cost—for the 1 per cent pay rise was the best way of spending the money. It would be quite possible for the chancellor to say that the Government will get rid of the pay cap but not give any more money and for the NHS Pay Review Body to come back with a suggestion of 1 per cent anyway. As I said, that would have no impact on the Scottish budget.

It is also possible for the chancellor to say that he will get rid of the 1 per cent pay cap and as a result give a certain amount of money to the key departments that are responsible for such services. In that case, the pay review bodies will need to make a judgment on how much of that should be spent on pay. If there were more money for services, that would have a knock-on effect on Scotland.

There are clear significant differences by region and by the type of public sector work but, if we put the whole lot together, it is not just the politics that is pushing for higher pay—public sector pay is now about back to where it was in 2008 relative to private sector pay. If the 1 per cent limit continues, pay in the public sector will fall quite rapidly relative to pay in the private sector and go to historically quite low levels. We will probably have to do something about public sector pay in the next couple of years.

The point about public sector pay now being where it was relative to private sector pay in 2008 is important. We tend to talk about such things separately. We talk about living standards and earnings having done really badly and then, completely separately, we talk about public sector pay having done really badly. However, public and private sector workers have gone in lock step. They have got there in a different way, but public sector workers have not done any worse than private sector workers over the period, on average.

Neil Bibby: You say that, in the short term, there might not be a disproportionate impact on the Scottish budget. However, in the longer term, because of the higher proportion of public sector workers in Scotland and the fact that raising revenues in Scotland is now vital to the Scottish budget and economic growth, do you accept that lifting the public sector pay cap would help the Scottish economy?

Paul Johnson: That depends on how the increase is funded. If more Barnett consequentials came to Scotland because more money was being spent in England, that would help the Scottish budget. The fact that the proportion is higher means that the knock-on effect would be higher than the Barnett consequential would necessarily fund but, as you said, if the public sector has a greater proportion of the Scottish workforce, it is a more important part of the Scottish economy.

Neil Bibby: Obviously, lifting the public sector pay cap would cost money. Your submission says:

> "To give one example the government could choose not to implement the planned cut to the corporation tax rate from 19% to 17%. That would raise an additional £5 billion".

Given that £5 billion is a huge amount of money and given the pressures to increase public sector pay, how likely is it that the corporation tax rate will be cut and the public sector pay cap will not be lifted?

Paul Johnson: I would not want to put probabilities on that. If I were the chancellor, with the current difficulties and with the knowledge that the parliamentary arithmetic makes most tax rises quite difficult, and if I was looking for additional money, not implementing something would look a lot easier than raising something. The problem is that the corporation tax cut is legislated for, so the Government would have to legislate not to bring it in. I do not know whether the chancellor will do it, but he is bound to be considering it.

As you said, part of the trade-off is that the extra £5 billion would help with public sector pay and other priorities. However, the chancellor might not reverse the corporation tax cut precisely because of Brexit issues. We know that the uncertainty around Brexit is reducing the long-term investment that some big companies would have made and, although small cuts in corporation tax do not have big impacts on such things, they might be seen as a signal of support. The choice is not straightforward but—I am sorry for repeating this—if I were the chancellor and I wanted an extra £5 billion of revenue, that option would be pretty close to the top of my list.

The Convener: Before I bring in Patrick Harvie, I have to say that you have in the past made some very strong comments about pay levels in general. Last November, you said that one

> "cannot stress how extraordinary and dreadful"

the situation is.

Moreover—I hope that I have got this right, and that people have given me the right briefing—I think that you said yesterday that we now have the lowest wage growth "since the 1750s".

Paul Johnson: I was quoting Mark Carney.

The Convener: It was Mark Carney who said it. What concerns me is the cumulative impact on people's living standards of the stuff that you were talking about with Ash Denham with regard to the single market and that low wage growth. Would you like to say a bit more about that?

Paul Johnson: It has been an extraordinary decade in all sorts of ways. Average earnings today are still below what they were in 2008, which is astonishing. People dispute whether the last time we had a decade this bad was in the 1750s, the 1800s or the 1850s, but as far as earnings are concerned, it was certainly a very long time ago. I also point out that younger people have been hit worst: the earnings of people who are in their 20s now are still significantly below the earnings of people in their 20s in 2008, whereas the earnings of older workers have generally recovered. There was a period in 2014-15 when real earnings were beginning to rise, but the spike in inflation that we have had this year means that, over the year, real earnings have started to fall again. As we have discussed, that is directly related to the fall in sterling.

We hope that earnings will start to rise again, but given the discussion about the economic uncertainties around Brexit, I presume that they will rise less quickly than they would have done in a different world, in which we were not leaving the European Union. The OBR's projection is that average earnings in 2020 will still be below where they were in 2008. In a sense, that does not really matter, because it is just a statistical artefact, but in the OBR's judgment, that is something that tipped after the EU referendum. In March 2016—before the referendum—the OBR thought that, by 2020, earnings would go above their 2008 levels, but after the referendum, it thought that they would not.

Patrick Harvie (Glasgow) (Green): Good morning. I want to explore some of the figures that you have given us on public sector pay. I am glad that in your comments in the last few moments you acknowledged the difference between people's real experience and the average, because I hope that we would all be concerned about the level of inequality rather than just the average.

You have suggested that

"Increasing average public sector pay in line with either prices or private sector earnings would increase the cost of employing the 5.1 million public sector workers by around £6 billion per year by 2019-20."

I assume that those figures are based on the full UK-wide public sector, and not just people who are directly employed by the UK Government and subject to pay negotiations on a direct basis. Are you talking about all the other public sector bodies?

Paul Johnson: Yes.

Patrick Harvie: Does that figure take account of the additional income tax that would be paid, or of other indirect effects? In other words, is it a measure of the affordability of such a move, or is it just to do with the pay bill itself?

Paul Johnson: That is a really good question. The answer is yes—we have tried to take account of the effect of income tax, national insurance and pension contributions.

The gross number is about £9 billion, which is a number that we are quite confident about. The net number, which is a lot more difficult to calculate—that is why we use words such as "around"—is around £6 billion. That is the number for affordability across the public sector, and it is really important from the point of view of any individual department. The health service, for example, will feel the gross cost, whereas the Treasury will feel the net cost.

10:15

Patrick Harvie: That relates to Neil Bibby's point about the size of the public sector in Scotland relative to the UK as a whole. If more income tax revenue is being generated in Scotland, that can have an effect on the block grant adjustment mechanism.

Paul Johnson: Yes. It would possibly ensure that income tax revenue in Scotland rose a bit faster than that in the rest of the UK.

Patrick Harvie: Not massively, but it could be—

Paul Johnson: On the other hand, the UK Treasury could get your higher national insurance contributions, for example.

Patrick Harvie: Other indirect effects might include reduced demand for social security payments of various kinds, or reduced demand on the health service—if we are talking about public sector workers, many of whom are low earners. A reduction in the amount of direct poverty that many of those workers are in would have a positive effect in other public service areas. Have the indirect effects that are one more step removed from the direct pay bill been taken account of?

Paul Johnson: No. We cannot take account of those effects. Clearly, there are low-paid public sector workers and some of them are on benefits, but about two thirds of public sector workers are graduates. The average pay of a public sector worker is actually much higher than that of a private sector worker, because the public sector is such a graduate and high-skilled workforce. The lowest-paid public sector workers—the least-skilled public sector workers—command the biggest premium over the private sector. Poverty pay is much more a private sector problem than it is a public sector problem.

Patrick Harvie: Sure.

Finally, is the Scottish Government, in its response to whatever the UK Government does in its budget, in a position to easily calculate the total cumulative affordability of increasing public sector pay by inflation or above inflation, taking into account not only the direct effect on the pay bill to itself and the other public sector bodies that it funds, but the knock-on effects on taxation and devolved elements of social security or other public services? Is that an achievable calculation?

Paul Johnson: Yes. That calculation ought to be achievable.

Patrick Harvie: Is anybody other than the Government in a position to do that calculation? Can it be done based on information that is already in the public domain?

Paul Johnson: It is probably best to ask the people who are sitting behind me—Professor David Bell and Professor David Heald. It may well be that the Fraser of Allander institute or David Bell or somebody else can do that calculation—I do not know.

Patrick Harvie: Thank you.

Alexander Burnett (Aberdeenshire West) (Con): This is a change of direction, to an "If you were chancellor for a day" type of question. You have written at length about how you would improve the UK tax system to make it more efficient and effective. You are here in Scotland, so can you put yourself in the Cabinet Secretary for Finance and the Constitution's shoes and suggest any obvious ways in which the Scottish system could be similarly improved—bearing in mind that you would have to get cross-party support for any such suggestions?

Paul Johnson: Scotland obviously has many more constraints on what it is able to do. A lot of the big problems with the UK system sit with capital taxation, national insurance contributions and the VAT system, none of which can be changed in Scotland. Structurally, many of the problems are not within the Scottish Parliament's purview—certainly, many of the biggest ones are not.

On the things that are within the Scottish Parliament's purview, taxation of housing remains a huge issue across the UK. Our view is that there is a strong case for a rebalancing away from stamp duty in England and from the land and buildings transaction tax here, and towards council tax. I know that council tax was frozen here for a long time.

There is a strong economic argument for council tax to reflect more closely the value of properties, rather than being regressive in terms of its being based on an out-of-date valuation of a property. I might, if I was chancellor for a day, reduce the transaction tax and reform and increase council tax, which would help with the functioning of the market and with the inequalities between generations, which we have not talked about. The current system benefits those who own expensive properties and is a problem for those who want to get into the housing market. The tax system makes that situation worse. There are definitely things that you can do within taxation of housing.

Scotland also has choice in the income tax system, obviously. There is not much that you could change structurally—a lot of the problems are about how the income tax system treats earnings relative to capital income, which I understand the Scottish Parliament cannot shift. One thing that you could do, for example, is move away from the rather silly 60-odd per cent rate on earnings between £100,000 and £120,000 that we have under the current income tax system. You may or may not decide to do that.

The Convener: Could you expand on what you mean by "move away?"

Paul Johnson: At the moment, as you know, the personal allowance is so-called taken away for people who earn between £100,000 and about £120,000 a year, which creates a 62 per cent marginal tax rate for those people, when national insurance is included. You could just stop doing that, at some expense and—obviously—in a way that would help high earners. You could, instead of having the 60 per cent rate over that £20,000 range, have a lower rate over a £50,000 range, for example. I do not present that tax rate as being a big priority, because it does not do any great harm—although a person who earns £120,000 probably thinks that the situation is a little unfair.

The Convener: You said that the significant levers in the economy remain with Westminster and the UK Government. Given that the new fiscal framework means that we have to match or outgrow the UK economy if we are to have a net benefit to our settlement, what is available in the basket that we have that would start to make a difference?

Paul Johnson: The issue is between the short run and the long run. My view is that Governments can do quite a lot in the long run by investing in appropriate infrastructure, having a good education system, having an effective planning system and things like that. Things that focus on long-run economic development will pay dividends in the end.

In England, the slowness over making big infrastructure development choices—whether it is about Heathrow or anything else—clearly holds the UK back because of the trade-offs that are involved. A Scottish system that is better at choosing infrastructure projects and doing them quickly would help.

England has a dreadful education system for anyone who wants to move on from school at 16 or 18 and do anything other than go to university, and that holds the economy back. If Scotland were to get that situation working better, particularly in the further education sector, that could have a significantly positive impact relative to the rest of the UK.

Immigration is the other thing. Someone said earlier that Scotland has much less net immigration than the rest of the UK. I find that quite surprising in some ways, given that you have some of the world's best universities and so on. Anything that attracts more people—not just high-skilled people, but certainly including high-skilled people—to Scotland over time would clearly help the economy to grow, particularly given overall immigration policy. Given how the formula works, that would have a big positive benefit.

The Convener: Thank you. That is very helpful.

Maree Todd: Something dawned on me as I was listening to all the discussions this morning. I am aware that the UK's credit rating has been downgraded. What impact is that likely to have on the public purse, given the cost of debt? Are there any predictions about where that is likely to head in the future, with the shrinking of the economy that we have been chatting about this morning?

Paul Johnson: I do not think that the downgrading will, in itself, have any impact. I am not sure that people who buy gilts take much notice of such things, so I wonder what the point of that is, if I am honest. The downgrading could be taken as a symptom of increased uncertainty about where the UK economy is going. Without making any judgments, I say that we clearly have quite a lot of political uncertainty. We have a UK

Government that barely has a working majority, which will, for example, make increasing tax very difficult, should it become necessary. I have said that one of the big constraints on the chancellor will be the difficulty that he would have getting any tax increases through Parliament. Political uncertainty clearly creates risk.

The uncertainty around what the Brexit deal will look like also creates risk. Again, without making judgments, I say that the UK Opposition party has a set of economic policies that are very different from anything that we have seen in a couple of generations, so people will see that as creating some kind of risk as well as potential opportunities.

Put together, all the concerns about political capacity and uncertainty over growth will, or might, eventually weigh on people's willingness to purchase UK Government debt. However, let us be absolutely clear: at the moment, people are still desperate for this stuff and the interest rate that is being paid is extremely low by historical standards. That is partly a good thing, but it is also partly a reflection of the concerns about the world economy. The fact that people are still willing to buy this stuff when it has negative real returns is an indication of how worried people are about where the world economy is going.

What would be really worrying for the UK—this might be where we are going—is a world in which investors become more confident about the rest of the world: we know, for example, that euro zone growth has been quite strong recently. If investors start to get more confident about the rest of the world and less confident about the UK Government, at that point, the cost of the debt might start to rise.

The Convener: I see no one else indicating that they have a question. That hour of your time was useful. I am grateful to you for coming along this morning and giving us your thoughts, in order to set the context for us as we begin to drive towards the setting of our budget at the end of this year and the beginning of next year. The context is important in that process, so we are grateful to you.

10:28

Meeting suspended.

10:33

On resuming—

Brexit (Impact on Scottish Budget)

The Convener: Agenda item 2 is a discussion on the impact of Brexit on the Scottish economy, which is part of our focus for budget scrutiny this year. We are joined by Professor David Bell, who is a fellow of the Royal Society of Edinburgh, and Professor David Heald, who is professor of public sector accounting at the University of Glasgow.

Thank you for providing the committee with your written responses. We will move straight to questions. Adam Tomkins will begin with questions on growth.

Adam Tomkins: I should say for the record that I am also a fellow of the Royal Society of Edinburgh, although I had nothing to do with the preparation of these papers. I do not know whether it was relevant to declare that interest.

Professors, you heard our earlier witness, Paul Johnson, say that there is an unprecedented level of uncertainty in the economy. Do you agree with that?

Professor David Heald (University of Glasgow): Yes. The striking thing is that we have a coincidence of three major issues at the same time. The first point is that the basis on which the Scottish Parliament is funded has fundamentally changed. We are moving from the position in 1999, when it was essentially funded by block grant but with some tax powers in the form of the tartan tax and local government taxation, to a position in which the funding of the Parliament depends on the performance of the UK economy and on the performance of the Scottish economy relative to the UK economy.

The second point is that we are going through the longest period of fiscal austerity for 100 years. It is not the deepest but, generally speaking, periods of public expenditure cuts and tax increases usually last for a relatively short number of years, whereas it looks as if the whole of the 2010s will be affected.

The third point is obviously Brexit. You heard from the previous witness that the balance of economic opinion is that the effect on the UK economy will be negative. That will lead to the lower affordability of public spending at the UK level, and hence to less money coming down the Barnett pipeline. What deeply concerns me about that is that the whole of the public debate seems to be concentrating on what I regard as a pretty irrelevant issue, which is the divorce bill. The net UK contributions are about 1 per cent of total managed expenditure, so a relatively small item is dominating public debate and creating a pretty toxic atmosphere between the European Union and the United Kingdom, when important things such as trade and future relationships are what actually matter.

Professor David Bell (Royal Society of Edinburgh): I agree with the premise that we are in a period of considerable uncertainty. I would add a couple of points to what David Heald has said, one of which relates to austerity. What also lies behind that is something that Paul Johnson was talking about, which does not have its roots in Scotland. It is the question of whether a secular change is taking place in the UK's economic performance, and maybe beyond the UK, in terms of the lack of productivity growth and the slowness of recovery from the recession, which, as we have heard, is almost unprecedented historically. I have looked at the great crash and various other recessions that we have experienced during the 20th century—I have experienced more of them than most of you—and the duration of those recessions was much shorter than what we are experiencing now.

Secondly, in relation to Brexit and the way in which Scotland's finances will now be determined, what will matter a lot is the relative performance effect caused by Brexit on the Scottish economy relative to the rest of the UK. Ultimately, that will have a bearing on the block grant adjustment and therefore on the ability to fund public services.

Adam Tomkins: Given that you both agree that there is an unprecedented level of uncertainty, I would like to ask about some of the figures, particularly those in Professor Bell's paper. You have given some disturbing, alarming and concerning figures about forecasts of growth, particularly with regard to gross value added and various of Scotland's economic powerhouses and cities. Given that level of uncertainty, how seriously are we to take those figures? How robust are they?

Professor Bell: That is a fair point. That work has been done by Henry Overman and Stephen Machin at the London School of Economics. It is based on an overall model of trade effects on the UK, so it is looking at the long-term impacts of changing trade patterns in the first instance, and then bringing those down to a spatial level and looking at the effect on areas and cities. I would say that the figures are indicative; I would not go further than that.

Adam Tomkins: Is there any evidence to support those figures? They are forecasts, and we all know that forecasts can be wrong and can sometimes be wildly wrong. Is there any evidence at all that those forecasts are correct, or are they just guesswork?

Professor Bell: They are forecasts, so we cannot know whether they are correct until the time point by which they are predicted to occur.

One of the big difficulties that has not yet been mentioned is that the dynamics are really uncertain. You may remember that there were some who forecast the almost complete demise of the British economy the day after the referendum as a result of the Brexit vote. It seems to me that that was obviously wrong and those forecasts also failed to make it clear that one of the particular uncertainties is around when things will happen. If trading patterns change, how long does it take for businesses to decide to change their investment plans and for new contracts to be made and so on?

I would see the forecasts as indicative. Quite an important message that underlies a lot of them is that areas or cities that are particularly exposed are those that have high concentrations of private sector service workers. As we heard earlier, trade agreements that have much by way of agreements around trade and services are pretty thin on the ground, therefore those services may find post-Brexit life most difficult.

Adam Tomkins: I saw Gordon Brewer interviewing you about this on the television on Sunday. He put to you a question that I think it will be useful to get on the record at the committee. If those indications, as you call them, are the sorts of numbers upon which we should place any weight at all, would you not already expect to see business confidence beginning to diminish and business investment plans beginning to change, given that the plans are made in anticipation of the way in which the economy is developing? There is no evidence to support the idea that, for example, Glasgow's growth will be cut by the numbers that you have put in your submission.

Professor Bell: It is difficult to disentangle the effects of Brexit when we live in an economy where other things are also going on. We have already heard a discussion about the potential effects of the depreciation of the pound, which in some cities may have had beneficial effects. In trying to isolate the effects of Brexit, which is what Overman and Machin have done, they are being placed in a counterfactual where nothing else is going on, but other stuff is always going on.

Adam Tomkins: So we should not place too much weight on those figures.

Professor Bell: I think that they are useful indications and they make the basic point about trade that we are currently in a single market, in which we have extremely advantageous trading relationships, and are moving to a situation in which there is great uncertainty and there are all kinds of issues that trade economists would say would make life more difficult. I think that those are the general lessons that are worth placing some weight on.

Professor Heald: The relative performance of the Scottish economy seems to be a very important issue for the committee, because of the way that the fiscal framework works. One of the things that concerns me is the ramifications of the decline of the oil sector. I spent much of my working life working in north-east Scotland and the effects across the north-east economy of what is happening in oil can be seen very clearly. I suspect that the linkages are also affecting the rest of the Scottish economy.

10:45

If we are looking for reasons why this period has the coincidence of the factors that I mentioned, when the Scottish economy might perform worse than the UK economy, the ramifications of oil are important, as is the question of what kind of deals will be done to protect important parts of the UK economy. For example, if the UK Government makes trade-offs that protect the financial sector, there might well be benefits to the non-Scottish parts of the UK, particularly in the south-east and London. The relative performance has become very important, because how much the Scottish Parliament will be able to spend will depend in part on the relative performance and its effect on the block grant adjustment.

Neil Bibby: The impact of Brexit on cities in Scotland will not be uniform; it will be felt differently in different areas. I understand that the figures on gross value added that have been quoted are forecasts, but it would be wrong of us to ignore warnings about their impact. It was stated:

> "Aberdeen's GVA is forecast to fall more than any other city in the UK"

and

> "Edinburgh's GVA is forecast to fall by 3%".

There will be an impact not just on Aberdeen and Edinburgh, but on Dundee and Glasgow.

What Professor Bell said about the areas that will be worst affected having the highest level of private sector service workers was interesting. The evidence that we just heard suggested that they are also the lowest-paid workers. What will be the impact of the hit from Brexit on the poorest members of society?

You said that

> "The Scottish Government and the City Partnerships might wish to consider how"

best to mitigate the impact on the cities. What is your suggestion for how the Scottish Government, councils and city partnerships can best mitigate the impact?

Professor Bell: It is true that there are more private sector workers than public sector workers at the lower end of the pay distribution. However, it is also true that what we are talking about are effects that are largely to do with trade and which parts of the economy will be most affected by a different trading environment. The higher-paid private sector workers are the most likely to be affected. In Edinburgh, for example, if it becomes more difficult for life sciences to penetrate markets or for high-tech computing firms to break into new markets, those are the effects that are most likely to impact on the overall GVA in that city.

We should remember that, as far as the relative performance of Scotland is concerned, it is the higher earners that matter more, in a sense, because they are the bigger contributors to income tax revenues. Relative performance in relation to income tax per head will determine how the block grant adjustment evolves. That is not to say that there will not be trickle-down effects that will affect poorer workers, but the lesson that I took from Overman and Machin's research was not necessarily that that will particularly affect poorer people. Rather, it will affect cities as a whole, because it will have a negative effect on their trading relationships with those that they currently trade with, or could trade with in the future.

Neil Bibby: What about your call for the Scottish Government and city partnerships to look at ways in which they can mitigate the potential impact on cities?

Professor Bell: I could launch into an explanation of that, which the committee might find interesting, or it might not.

The issue of what will happen to the structural funds post-Brexit is important. One possibility is that that money will move into the city partnerships. That would change UK regional policy in the sense that, at present, we have some policies that are place neutral. That means that, to get that support, places have to qualify in terms of income per head, a measure of relative poverty or whatever. The standard measure that the European Union has applied in the latest budget is that regions that fall below 70 per cent of EU average per capita income are eligible for direct support. That now applies only to Cornwall and west Wales. If that money is taken and put into city partnerships, it will be allocated to places where deals are being done through engagement with other stakeholders. For example, the University of Edinburgh is a big stakeholder in the city deal, and so is the local authority. Deals such as that are done in places where there are actors that are willing to engage with them. If a similar place-neutral regional policy is not introduced, places that currently qualify for some EU-type support may lose it. All the money will end up concentrated in the cities and there will be left-behind towns, rural areas and so on.

This has to be thought through very carefully. It is not clear what the UK Government's thinking is about setting up some kind of fund. It is important to know where the social fund and the structural funds that currently come from Europe are going to end up. A decision has to be made about whether they will come to the Scottish Government or be retained and distributed at the UK level.

Willie Coffey: My question is on that very issue. God forbid that the structural funds cash will end up only in cities in Scotland. North Ayrshire and East Ayrshire would throw their hands up in horror at that prospect.

You touched on the fact that there needs to be a strategic approach. North Ayrshire Council's submission tells us that up to 25 per cent of Scottish councils' spend on economic development comes from the European Union and that it supports a wide range of things such as infrastructure, business investment and youth employment in areas such as North and East Ayrshire. I suggest to my colleagues round the table that the impact of Brexit will not be felt only in the cities and that there is a case to be made for having a regional policy in Scotland that continues to provide support. Is any work being done on what the impact might be in areas outwith the cities and on their councils?

Professor Bell: Some parts of Scotland and indeed large swathes of England qualify for transitional funding because their income per head is between 70 and 90 per cent of the EU average. There is also European social fund money, which I think is what you are referring to. No work is being done on that, as far as I know, because of the uncertainty about what is going to happen to those funds. Are they even going to be allocated to regional development? Are they going to be allocated at a Westminster level or will they go to the devolved assemblies?

A lot of this goes back to Keynes's comment that the things that practical men do are things that were thought through by some economist long ago. Ultimately, the argument is based on different views about where money should be allocated. This is not going to be good news for MSPs from rural areas because, basically, the argument is that concentrating resources in cities generates more returns. That is what lies behind the initiatives that have been taken at UK level in relation to cities in the past 10 years or so. That clearly goes against equity, but the argument is that concentrating resources in cities is more efficient. All that I say is that that kind of thinking lies behind decisions about the allocation of resources to different parts of the country. We currently have a mixed economic development set-up, in which the EU does not really care about where money goes as long as it goes to places that qualify, and the UK Government and the Scottish Government try to get people together to agree on policies to promote the growth of cities.

Professor Heald: We have gone on to the question of what happens with functions that are repatriated. There is much talk in the media of a power grab by the UK Government, which has upset the devolved Administrations. There is a crucial question about whether there will be UK common frameworks—in the context of agricultural subsidies, for example—and how they will be financed. Obviously, the UK Government could keep everything and just run it all from the Treasury. Alternatively, the existing Scottish spend on presently EU-financed functions could be transferred into the Scottish block, with future changes going through the Barnett formula.

I make the point in my memorandum that that will introduce a new set of controversies into the budget process, because there will be a direct conflict between spending money on nurses and spending money on sheep. Because it is done within a European framework, the budget is actually segmented—those two budgets are not fungible. As soon as we put it into the block, questions will arise about whether future changes that come through Barnett will be sufficient to pay for agricultural subsidies, and about what relative priority should be given. That is a very important issue for the committee to think about when it turns its focus to the specifics of the budget process.

Willie Coffey: I can almost see my colleagues in east Ayrshire, North Ayrshire and South Ayrshire reaching for their email in horror at the prospect of a city-only regional policy. We will get the spin-off benefit from that, of course, as we always have, but I do not think that they will really follow that. Is there a need to develop a more regional policy in Scotland around these types of frameworks so that we do not get left out and it is not just the cities that get the attention, through regional policy and otherwise?

Professor Bell: You could certainly argue that the kind of policy that I described—I do not necessarily subscribe to it—does not take account of the associated externalities. One of the externalities that we have seen in Scotland for a long time is the effect of young people being attracted to cities, and other parts of the country being left with much more challenging age structures than the average in Scotland as a whole. A lot of the consequences of that have to be borne by public services, which results in higher costs for hospitals, care and so on.

There is a good case for looking at economic development in the round—which I do not believe that the UK Government has done—and taking into account those externalities and equity considerations. Driving up GDP is not just about efficiency; it is also about maintaining a balance between different parts of the country.

11:00

The Convener: Earlier, David Bell spoke about the impact on higher-rate tax payers and the potential for greater attrition in terms of jobs and so on. I compare that with David Heald's paper, which talks about the numbers from the HM Revenue and Customs work in 2017 being "striking". It says:

> "Of 2,601,000 Scottish income taxpayers in 2014-15 paying £1.68 billion, the 4.38% with incomes greater than £50,000 accounted for 38.39% of that total."

Those figures are worthy of a bit more discussion. If I understand them correctly, the impact on that sector of Brexit and leaving the single market could have quite serious consequences for the income tax take in Scotland.

Professor Heald: About seven or eight years ago when I originally saw those figures in the HMRC survey of personal incomes, I was sufficiently shocked that I thought that I had calculated them wrongly. However, the figures are broadly consistent from year to year: roughly speaking, 5 per cent of income tax payers produce 40 per cent of Scottish income tax revenues. That shows the importance of thinking carefully about the effect on that group when the Scottish Parliament sets tax bands and rates.

There are two issues here. The first is the one that you have directly raised, which is the fact that people in the private services and oil sector have had very high incomes. Because of Brexit and other things that are happening, we have got to think very carefully about the relationship between the tax regimes of Scotland and the UK. I was one of the people behind the tartan tax proposal 30 years ago. It atrophied because so much money was coming down the Barnett pipeline. It is very important that the Scottish Parliament and the Scottish Government do not allow the Smith commission tax powers to atrophy. The point that I am making is that they have to be used carefully. A broader political point is that it is wrong to think that you can protect or fund increases in public services solely by taxing the well-off, such as additional-rate tax payers. In the context of continuing austerity and pressure on public services, if Scotland wishes to spend more, relative to what the Scottish block grant will fund, it has to face the fact that income tax powers will have to be used across the spectrum and across a broad base.

The other issue is that the Scottish Parliament does not have control over the personal allowance. Trying to use a zero per cent band would create complications with some social security benefits. However, Parliament has control over the bands. For a long time, my view has been that the higher-rate threshold is too low. From the 1980s, the UK has moved to a two-rate system: a basic rate and a higher rate. You need to think about what those bands should be, so that people on an income of £43,000 do not go from 20 per cent to 40 per cent.

The practical difficulty that we have is that the Scottish Parliament does not control national insurance. As a result, when one talks about the effect on individuals and households, one has to think very carefully about the relationship between marginal rates of combined income tax and national insurance.

The Convener: That was very useful. The position regarding Scottish taxation might or might not shift, but from what I took David Bell to say, even if all things are equal and nothing in the Scottish tax system changes, there might still be a negative effect on higher-rate taxpayers as a result of Brexit. In other words, even doing nothing might have an impact on the Scottish budget with regard to the amount of income we get from income tax. I wonder whether David Bell might like to say a bit more about that broader point, taking into account what David Heald has said about the impact of the choices that we make.

Professor Bell: As far as the Scottish budget is concerned, there is a level effect and a relative effect. The level effect is that, other things being equal, Brexit is more likely to induce falls in income among higher earners or, indeed, induce the emigration of higher earners, particularly EU nationals who currently live in Scotland, in both the public and private sectors. That is because those people have easier access to markets, countries or polities outside the UK where they might prosper relative to the UK, and they consider such options more of the time than low-paid workers do.

The relative effect comes through the block grant adjustment. The question in that regard is: who is doing worse with regard to high earners—the rest of the UK or Scotland? Notwithstanding the forecasts of the difficulties that particular cities might face, the expectation overall is that Scotland will be less affected than the rest of the UK. At the moment, it is difficult to predict how that will come through as far as those at different earnings levels are concerned, but clearly that sort of thing can affect the block grant adjustment.

The Convener: So—incredibly—the bottom line is that what happens to the City of London will have a huge impact on what happens to the Scottish block grant and what happens in Scotland.

Professor Bell: Yes, and although we have no direct evidence of investment intentions, I should say that I was at my daughter's primary school in Wimbledon yesterday and found that over the past year her class had been depleted by six kids, all of whom have European parents. There is already evidence of some changes taking place, but of course it is just hearsay until it enters the official statistics.

The Convener: This might get me into trouble, but it probably means that in order to further Scottish interests we in Scotland will have to stand up for the City of London.

Adam Tomkins: Can I tweet that?

The Convener: I said "probably". I did say that it would get me in trouble.

Professor Heald: Because it is such an important technical point, we have tended to stress the question of the importance of the Scottish economy relative to that of the rest of the UK. However, I think that, with regard to Brexit, the biggest effect on the Scottish economy and the Scottish budget will be if the UK economy does badly, because if that happens, we are likely to get an even longer period of austerity. Everybody must understand the significance of the block grant adjustment and the fact that the relative performance matters, but my major concern is the overall effect on the UK economy at a time when there are other reasons—such as the decline of oil—to be worried about the Scottish economy.

The Convener: Okay. It is all complicated stuff. I call Murdo Fraser.

Murdo Fraser: Professor Heald, I have to say that I do not understand your use of the term "atrophy" in relation to the Scotland Act 2016 tax powers. The Scottish Parliament now has to set tax rates on an annual basis; we have to have a positive vote in Parliament to set rates, and some of us might argue to keep them in line with those of the rest of the UK while others might argue for a different choice. How is it atrophy if the Scottish Parliament is taking a positive vote to set tax rates?

Professor Heald: I take your point. I was thinking very much about the 1999 tartan tax powers. I was around when those powers were being discussed, and at the time, people did not appreciate the significance of the Parliament not having to have a positive vote—I certainly did not. However, we found that one of the consequences of the Parliament not having to have a positive vote was that, over time, it became much more difficult to use the powers, partly because they had never been used. Furthermore, after a period of time, the administrative machinery collapsed without the Parliament being told that it had.

My concern about the present powers in the 2016 act is that, although I take the point—and welcome the fact—that a positive decision has to be made, the longer that those powers go without being used or are used in only a minor way, the greater the danger that, for example, HMRC's preparedness will decline. When I talk about things atrophying in this context, I am thinking about the two things that will happen if you do not use the powers: first, the administrative machinery will disintegrate over time, because it is costly to maintain; and secondly, the difficulty of making a decision becomes more severe.

Patrick Harvie: I hope that the discussion paper that the Scottish Government has committed to producing on income tax will give us an opportunity to avoid the atrophy that you are talking about.

Professor Heald, your written submission uses a phrase that I found interesting. It says:

> "for each tax within the Scottish Parliament's portfolio of taxes, there will be those who advance plausible or specious arguments about the economic benefits of tax reduction."

You mention a number of examples in relation to that, such as aviation tax. Is there a danger that income tax will be seen in the same way, and that that will lead to the kind of tax competition that leaves the revenue of all parts of the UK worse off?

Professor Heald: Yes. One of the things that filled me with a certain amount of disquiet during the Smith commission discussions was that loads of people in Scotland seemed to think that having more tax powers would mean that you would be able to spend more. It seemed that Scotland wanted more tax powers so that it could spend more and have a more generous welfare state and better public services. However, there has always been a different strand of argument, which is that a national Government that has to raise its own taxes will spend less. It is possibly why there was a move from a position at the time of the 1997 referendum in which there was substantial opposition to the tartan tax to a position at the time of the Smith commission in which it was almost as if everyone was competing to give Scotland more tax powers.

Of course, one of the difficulties is that, although Scotland now has substantial tax powers, they interact with other taxes. Essentially, the UK has two forms of income tax; in my view and in the view of most economists, national insurance is basically a second income tax, and the interaction of those taxes is extremely important. Committee members will probably remember that, under the Labour Government, Tony Blair and Gordon Brown promised not to increase income tax, so they increased national insurance contributions instead. The political relationship between those two taxes is important, but what is called income tax is probably far better understood than the operation of the national insurance system.

11:15

The other issue is that the Scottish Parliament does not set the tax base for income tax; the powers relate to only non-savings and dividend income. Therefore, there will be issues about the relationship between personal income tax and possible avoidance strategies such as incorporation into companies. There are also questions about the move towards self-employment and relative enforcement.

Patrick Harvie: Not for the first time, Adam Tomkins and I have apologies to make to the country on behalf of the Smith commission—for the complexity of the process, if nothing else.

I want to park some of what we have talked about, because it is not directly relevant to the discussions about the Brexit context, although it is obviously of huge importance generally. The political will to take a different tax policy is far more important than the debate on powers. Scotland has had very broad taxation powers with regard to local services, and there can be no greater example of atrophy than the failure to do anything serious with them over the years.

The potential changes with regard to Brexit that you have both touched on and which relate to whether people move, leave or organise their affairs in a different way in response to what is happening with Brexit and the economy bring me to a question about the potential impacts of tax changes at the additional and higher rates. The argument has been made repeatedly that increasing the additional tax rate might not generate additional revenue, because there will be behavioural changes. That situation might be exacerbated in the context of Brexit, given that people might already be thinking about relocating or arranging their affairs differently.

I have repeatedly asked a number of people, including the Government, whether there is any evidence that the same argument that is being advanced for the additional rate applies to the higher rate. Can either of you answer the question whether the higher rate of tax—or potential increases at the higher rate—is equally as vulnerable to such behavioural effects as the additional rate, and is there any way in which we can estimate the size of the effect?

Professor Heald: I cannot help on the question of estimating the size. I would make the point, though, that there are very few additional-rate taxpayers in Scotland. The number that we see widely quoted is 17,000, which is very small. There are a lot more higher-rate taxpayers.

My more general point about the higher-rate threshold is that when higher rates operated in the past, it was not expected that they would catch people on moderate incomes in the way that they do now. My argument about the higher-rate threshold being too low and there being insufficient graduation in the system is based more on equity. There is also a very important question about how much attention HMRC pays to the enforcement of residence rules.

Going back to the question of additional-rate taxpayers, I suspect that a lot of those in Scotland might have other residences, so the extent to which HMRC actually polices residence and makes sure that the system operates as the legislation intended is important.

Patrick Harvie: That is also less likely to be the case with regard to the higher rate.

Professor Heald: It applies generally about enforcement, but because so much money comes from the additional rate, the potential gains from avoidance behaviour become greater.

The greater concerns with regard to the higher rate are about incorporation. As you might well remember, Gordon Brown as chancellor provoked an enormous increase in incorporation with the introduction of a zero-rate band of corporation tax, so there is past evidence that taxpayer behaviour can actually be quite sensitive. The UK is an unusually fiscally centralised state. In Canada or the United States, the idea that a different province or state might have a different income tax—or no income tax at all—would create no surprise whatsoever.

Patrick Harvie: The same is true in plenty of other European countries.

Professor Heald: Yes, and in a geographically compact country such as the United Kingdom with no tradition of income taxes being differentiated geographically, one has to ensure that the administrative system works properly. In my view, there needs to be caution in the way that those powers are operated. On a more political level, I repeat the point that, if the Parliament wishes to protect public services from future austerity, the use of the income tax powers should be across the board and should certainly not concentrate solely on the additional or higher rate.

Patrick Harvie: So you are calling for caution but not atrophy.

Professor Heald: Yes. Caution but not atrophy.

Patrick Harvie: I know that Professor Bell wants to say something about that, but I presume, Professor Heald, that you would agree that changing the higher-rate threshold is not the only—or perhaps not the most effective—way of achieving better graduation. We do not need to assume that one basic rate for an entire swathe of income needs to stay for ever.

Professor Heald: I absolutely agree.

Professor Bell: I agree pretty much with what David Heald has just said. Paul Johnson might have different views, but I know of no evidence on the higher rate per se. I do know that it is quite difficult to work out the effects.

Adding to what has already been said, I would suggest that another option that people might take in relation to Brexit is not to come here at all, which is something that the higher education sector is aware of at the moment. As for income tax in general, Brexit might make the option to move something that certain classes of worker will consider more than has been the case in the past.

David Heald has talked about the redefinition option, which relates to incorporation for higher-rate taxpayers. There are two classic reactions that people might have to higher tax rates: one is to work fewer hours, which is probably important for married women and for older workers in general; and the other is to decide that life holds other challenges than working and to drop out completely. You might think that that does not really happen very much among working-age people, but one of the big changes over the past 10 years—and in this respect, I would reference what Paul Johnson said about intergenerational equity—is that the fastest-growing group of workers are those aged 50-plus; indeed, HMRC has said that it is surprised by the increase in income tax revenues from those aged 65-plus. People are staying on longer, and that is helping to boost income tax revenues. There is a huge opportunity to do some work on that to try to understand it better, but in thinking about bands and rates, you have to think about all the different options that people might have when confronted by either a fall or a rise.

Ash Denham: I want to ask about the Brexit divorce bill. I know that Professor Heald said that it is pretty irrelevant in the wider scheme of things, but it seems to have caught people's imagination somewhat.

The RSE paper suggests that the bill might be around the £36 billion mark and says:

> "If, however, additional payments form part of the final divorce bill, then there are likely to be consequences for the Scottish budget".

Can you explain that for us?

Professor Bell: I will need to remember why that was the case in the paper.

If the UK is paying more to the EU than expected, there will be no consequentials because the other things that it might have spent its money on, such as health and education, will not be available as options. The higher the bill to exit the EU, the less money will be available for UK domestic services, and that will affect the Scottish budget with regard to the extent to which those services have Barnett consequentials. We have heard that some parts of the public services budget are under huge pressure at the moment—health is the obvious one—and that will immediately have Barnett consequentials. That was the thinking behind the wording in the paper.

Professor Heald: One of the aspects of the devolved funding system, even after the fiscal framework, is how much discretion is in the Treasury's hands. If the UK paid a £50 billion divorce bill, what would happen would depend on whether the Treasury said that that had to be fitted into one year or over several years against the current envelope of total managed expenditure. If the Treasury said that it was going to be a one-off, there would be no Barnett consequences, because it would not displace expenditure that would generate such consequentials. That is a good example of how, even with the fiscal framework, so much depends on the discretion of the Treasury.

Ash Denham: At this point, is there any way of putting numbers on what the impact on the Scottish budget might be, or is it too early to say?

Professor Heald: There are two big choices. The first choice is whether it is a lump-sum payment made in one year or a payment spread over a number of years. The second choice is whether it scores against current expenditure totals or whether it is a one-off. If it scores against current expenditure totals, it will depend on what gets displaced and whether what is displaced is Barnett relevant.

Maree Todd: As a representative of the Highlands and Islands, I am, as you can imagine, hearing a great deal of concern about the potential uncertainty around common agricultural policy funding. Can either of you give me an idea of how significant a contributor that is to the economy compared with other forms of EU funding?

Professor Bell: I have forgotten what the current Scottish spend on CAP is.

Professor Heald: It is about £500 million.

Professor Bell: I was going to guess about £470 million.

The role that CAP spend will play in relation to the general Brexit debate will be much larger than its size in the economy, because there will be conflict around which powers are retained at Westminster and which are handed on to the Scottish Government. The agenda here relates to free trade. Currently, there is a group in government that is very keen on free trade, which means no tariff barriers on goods traded. The highest tariffs by some distance are those on agricultural goods; on beef, for example, we are talking about a rate of around 80 per cent. If the UK Government wanted to enter into a free-trade deal with another country, its ability to continue to subsidise agriculture would be in question.

11:30

Interestingly, the EU's deal with Canada has not resulted in changes to the CAP in Europe. Relative strength matters in this area. If you are doing a deal with someone, a key question is: who has more at stake? If the UK wants to be in a position in which it is willing to put everything on the table—because it might, for example, want concessions for another sector—its ability to continue to protect agriculture might come under threat.

Professor Heald: It comes back to my point about whether there will be common frameworks in the areas where the UK has previously not needed its own common framework because an EU common framework has been in place. A subsidiary question is: who actually makes the decisions about that? Will it be negotiated with the devolved Administrations, whose agriculture sectors are more dependent than England on subsidies, or will the UK Government impose a framework, because it wishes either to assert itself or to keep its hands free in the context of the free-trade agreements that David Bell spoke about?

Professor Bell: Interestingly, the part of the UK that is most dependent on agriculture subsidy—much more so than Scotland—is Northern Ireland.

Maree Todd: When we talk about efficiency versus equity in the Highlands, the argument that I have heard regularly is that CAP funding is actually one of the most efficient ways of injecting money into the local economy. In the Highlands and Islands, the money goes directly from the farmer's pocket to pay vets' bills or purchase feed. Do you have any thoughts on that? If such an option is not available to the UK—presuming, of course, that those powers go to the UK Government—is there another more efficient way that you can suggest of subsidising a rural economy?

Professor Bell: Over the years, the EU has gradually moved away from the idea of subsidising output—for example, the production of wine or sheep—towards encouraging farmers to produce the kind of goods that it wants, which might include, say, a better environment rather than sheep. The EU also wants to protect rural communities. Different streams of funding go through the CAP, some of which may end up in vets' bills.

Standing back from that, the question is: what do we want the agriculture sector to produce? Is it vibrant rural communities, an outstanding environment or greater output? The way in which we design the agricultural payment system will provide the incentive for farmers to do one thing rather than another.

All of that is up for grabs. If we are going to redesign our agricultural support system—indeed, if we are to have one at all—those kinds of issues will have to be thought through. It is an issue for the Scottish Parliament and the Scottish Government.

Maree Todd: I imagine that there might be significant policy differences between the Scottish Government and the UK Government in the areas that you have just mentioned.

Professor Bell: There are bound to be, because the structure of agricultural production is quite different in England and indeed in Wales. What happens in Scotland is not the same.

The Convener: Does Ivan McKee have a supplementary on that?

Ivan McKee: No, but I have a couple of other points.

The Convener: I will take Murdo Fraser's question on structural fund issues first.

Murdo Fraser: I have a couple of points to raise, one of which is on structural funds. I listened to all that you had to say and it was very interesting. We all understand that Scotland does relatively better from structural funds than many other parts of the UK. You can tell me whether you agree or disagree. Are you really saying that we should replace structural funds with some other source of funding that needs to come not through the Barnett formula process, which might disadvantage Scotland, but through some new system of regional policy funding?

Professor Heald: When the Scottish Parliament has got new functions in the past—rail franchising being the obvious important example—the spend in the year before it happens gets transferred into the block and the formula is used subsequently. It is not a question of getting a population share of UK spend.

Professor Bell: I agree with David Heald on that.

I did not really bring out the other point that lies behind this. Another thing that will be up for grabs is the ability of different parts of the UK to provide direct support to industry. For many years, Scotland has, under certain conditions—such as when the EU agreed that it did not significantly jeopardise the internal market—been able to spend money on regional selective assistance for particular companies coming in.

Regional selective assistance died a long time ago in England; it is not one of the options that is allowed to be applied in England. We have to think through the size of the structural funds as well as all the rules around when support can and cannot be given. It appears that the EU was content for Scotland to have a slightly different set of rules than was applied in England. Therefore, when those rules come up for discussion, it will be interesting to see whether the UK Government is willing to negotiate a continuation of that kind of difference between different parts of the UK.

Professor Heald: If you look at the Treasury's annual public expenditure statistical analyses, you will see that the index of public expenditure on economic developments in Scotland is vastly higher than the UK average. Within the umbrella of EU funding, Scotland has maintained a system of industrial support, which, as David Bell said, has tended to wither in England. In terms of the internal UK market framework, that will be one of the issues up for discussion.

One of the things that concerns me about the expenditure side and the tax side is that, freed from EU constraints, which everyone has blamed for lots of things, there is a danger of competitive subsidy bidding within the UK, and also a danger of competitive bidding on the tax side, as with proposals to reduce air passenger duty.

The Convener: We can only lose in Scotland if that happens.

Professor Heald: My view is that Scotland, Wales and Northern Ireland should avoid that kind of competitive bidding with England.

Murdo Fraser: Although it does happen to an extent already.

Professor Heald: Yes.

Murdo Fraser: I have one other question, on a different topic. It follows from Ash Denham's questions about the impact on the budget. What seems to be missing from your papers is any recognition that there will be a net benefit to UK finances from leaving the EU. It might not be £350 million a week, but Paul Johnson said earlier that it would be £8 billion a year net. Even factoring in the prospect of a divorce bill, in the longer term, could that not mean that would be more money to spend rather than less?

Professor Heald: I was at the back listening to Paul Johnson's evidence. What he said was that the overall fiscal effect would be negative because of the effect on the forecast growth of the UK economy.

I have seen various figures on the UK contribution to the EU in different years, and it is a net contribution of about £8 billion to £10 billion per year, but one must not just look at the budget numbers; one must think about the affordability of future plans in relation to the growth of the economy. On one level it is right to say that £8 billion will be freed up, but the overall economic context will be more difficult.

Murdo Fraser: That is the forecast.

Professor Heald: Sure.

Murdo Fraser: As we know, forecasts might or might not turn out to be true. I am just surprised that none of that is recognised in either of your submissions to the committee.

Ivan McKee: I want to touch briefly on two or three points. The first goes back to Neil Bibby's earlier question about the best thing that Government can do to mitigate the impact of Brexit on the cities. I agree that the best thing would be to find a way to stay in the single market.

Professor Heald: My personal view is that the UK should not leave the single market or the customs union. I accept that the direction of travel is that both will happen.

Professor Bell: My view is that it is likely to happen irrespective of whether I think it is a good idea or not.

I mentioned scenario planning in our paper for the committee. There is an argument for thinking through what the implications of different types of Brexit are and, indeed, a hard Brexit would pose particular challenges to industry. I guess that the Scottish Government might have a role in trying to mitigate the effects of the challenges that industry could face.

For example, what issues might our financial sector face in accessing markets that it currently accesses if there is no agreement and we fall back on World Trade Organization rules? We know that the Royal Bank of Scotland is thinking about setting up an office in Amsterdam.

There might be real issues for even quite small businesses in Scotland, such as food exporters. What kinds of things do they need to be thinking about if they want to get through a hard Brexit?

Ivan McKee: Yes. However, a soft Brexit, by my definition, would be staying in the single market, whether in a UK context or a Scottish context through a differentiated solution.

My second point—and I cannot let this go—is that I am surprised that people are surprised that only 4 per cent of the tax base raises 40 per cent of the revenue. That is classic Pareto, and nobody should really be surprised at that.

My substantive question is on immigration, which is raised in David Bell's submission. You will have heard me ask Paul Johnson about this earlier, but what do you think will be the medium to long-term impact of a significant reduction in net immigration into Scotland or net migration from Scotland on growth rates, public sector finances and, given the age profile of those concerned, tax take and pension rates? Secondly, if Scotland were able to achieve a differentiated immigration solution similar to that in Canada and Australia, what opportunities would that present to the Scottish Government and the Scottish economy?

11:45

Professor Bell: The fact is that Scotland attracts a relatively small proportion of UK migrants. It is surprising that Scotland is such an outlier, given its income per head; you would expect it to attract quite a lot more, but it does not and we do not know exactly why.

As a result, if the UK reduced net immigration to the tens of thousands, it would be difficult to see net immigration to Scotland being anything more than 10,000, and even that might be pushing it. Over the long term, that will have demographic implications, because it will effectively mean that the population will be bound by a lack of net inflow; deaths and births will be more or less equalised; and the population will more or less stabilise at 5.4 million or whatever it is at the moment.

As for the effect of that on the economy, I go back to Paul Johnson and the fact that it is important to differentiate overall GDP and GDP per head. If the population is not increasing, GDP itself can be stable while GDP per head—

Ivan McKee: But growth rates are always based on total GDP, so let us just stick with that.

Professor Bell: That is true, but as far as living standards are concerned, what actually matters is GDP per head. In any case, a slowdown in migration will certainly result in slower GDP growth.

It is more difficult to say what would affect GDP per head, but we also have to take into account the other on-going effect that you have mentioned—the ageing population. That is already affecting Scotland more than it is the rest of the UK, and it means that a relatively larger proportion of people in Scotland will be outside the labour market than will be the case in the rest of the UK, unless, of course, more people continue to work into their 60s and 70s. That would result in a less optimistic view of the Scottish economy in the medium to long term than would be the case if net immigration remained roughly at the levels that we have experienced over the past 10 years or so.

Ivan McKee: What about the question of whether a differentiated solution could offer any opportunities?

Professor Bell: It is almost like the situation with taxation. There are countries where immigration is set centrally; in other places, it is set by subnational Governments and national Governments in consultation; and there are places where the subnational Government plays a leading role. There is a very good paper by Christina Boswell that explores the possibilities for a differentiated migration policy in Scotland.

One could conceive of policies—I can go into detail if you like—that do not necessarily threaten the overall target for the UK but nevertheless allow for some differentiation in Scotland.

The Convener: Alexander Burnett has been very patient but two members have indicated that they have supplementaries on what Ivan McKee asked. Can we make these tight, please?

Patrick Harvie: I just want to make sure that I have understood two points properly. The first relates to Murdo Fraser's questions about potential longer-term opportunities and the fact that your submissions and all the other written submissions, as far as I can see, talk about the economic harm of this process and not about potential benefits. Is it fair to say that even a hard-right, fully signed-up Brexiteer with a vision of the sunlit uplands of empire 2.0 can make a rational argument only about the scale of the damage that the process of leaving will cause, even if they think that there might be further opportunities in the long term? Is there any plausible scenario in which the taking of this country out of the European Union will not cause economic harm?

Professor Heald: There has been some discussion in the newspapers about Singapore-on-Thames and the logic of leaving if the UK was going to go into a low tax, low regulation, low public spend environment. I would not support that policy but I understand the logic.

One of the things that I find striking is that we seem to be delaying the date of exit from the European Union by two years because of the transition period. That will create its own difficulties because decisions will be taken by, and the UK will be making contributions to, a body on which it has no representation. I can imagine a new wave of difficulty there.

I do not understand the argument that we leave the European Union and then bind ourselves to basically the same regulations and financial contributions similar to those that we already make. If I wanted to construct an argument in favour of Brexit, it would be a question of making a complete break with the European social model and the heavily regulated European economies. I do not see the point of mirroring those regulatory regimes to secure access to markets.

Professor Bell: It is difficult to predict what effect that kind of transformation would have. It would require huge structural change in the UK economy. People would be doing things quite differently and different things from what they have done before. I do not think that the benefits of that can come through in the short to medium term.

All the recent research on trade patterns shows that geography still matters. Value chains are centred in the world around China on the one hand, Germany on the other, and the United States on the other. The countries around them trade with them extensively. We are moving out of the ambit of one of the three key trading partnerships in the world.

Patrick Harvie: In response to Ash Denham, you talked about the divorce bill. Have I understood you correctly? Did you say that if the UK Government wants to avoid adding another dose of something toxic to the relationship between itself and the Scottish Government, it has complete freedom to decide to pay that divorce bill in a way that avoids a knock-on consequence to the devolved Administrations' budgets?

Professor Heald: Yes.

Patrick Harvie: Thank you.

Willie Coffey: How realistic is it to suggest that leaving the single market and paying the divorce bill means the end of everything and that we will not pay a further penny, when you consider that we are inextricably linked to the digital single market in Europe? There is a huge range of services that we currently share and will continue to share beyond Brexit, and it is ridiculous to suggest that we will get that for nothing. Roaming charges have been flattened out, online content will be available right across Europe from next summer, and there are general data protection regulations coming in that the UK is signing up to. There are huge amounts of digital infrastructure already in place, so is it not ridiculous to say that we will pay a one-off bill to say, "Cheerio", but continue to use all that? Is it not a bit like saying that we will be off the bus and on it at the same time, when it comes to the digital market?

Professor Heald: To the extent that you are picking up on what I said, my personal view is that it would be sensible if the UK completed the discharge of its financial obligations to the European Union, so that there could be a clean break. At that point, you discuss what future collaborations you will have.

Willie Coffey: And pay for.

Professor Heald: Almost certainly the European Union will expect the UK to pay for them. However, I want to make it quite clear what the divorce bill is. On the day that divorce takes place, there is a clean break. If you want future relationships, such as contributing to the Erasmus programme or horizon 2020, which are important for Scottish universities, you will have to pay for that. It is quite transparent in terms of presenting to the public that the divorce is over and that our future relationship is something that we will conduct on a transactional basis.

Willie Coffey: Could we be out of the single market but in the digital single market at the same time?

Professor Heald: I confess that I do not know much about the digital single market.

The Convener: I am sure that David Bell will enlighten us.

Professor Bell: Not really. I think that all those things—whether we are in horizon 2020 or the digital market—will be determined by negotiation. A lot will depend on European politics and whether they particularly want to engage with us or not. It is unlikely that it will be a free lunch for us.

Alexander Burnett: Given the noise of Brexit, one of the most incisive points that I have seen put on paper to date is one of Professor Heald's conclusions, which states:

> "Conflicting forecasts of prosperity or doom ... align with the individual ... view of the desirability of Brexit".

Where do you put yourselves in relation to that statement?

Professor Heald: As I said at the beginning of my contribution, we live in an age of remarkable uncertainty. Economic models tend to be calibrated on the basis of past experience. There is much rhetoric, but people are talking about Brexit being the biggest change in Britain's relationship to the outside world since 1945. To some extent, existing data will not tell you what is going to happen.

One point that I forgot to make earlier is that I am surprised that we have not talked more about the cost pressures on the Scottish budget, which are partly Brexit related in terms of exchange rate depreciation, but also related to the issue that I raised at the beginning about the long period of austerity. One of the reasons why the public sector pay cap may be coming to an end is that, apart from the political difficulties that the Government experienced at the most recent election, recruitment difficulties are beginning to appear that might be accentuated by Brexit through losing access to the European Union workforce, as working in Britain will become less attractive to European Union workers.

One has to think through those issues. If there was a sudden release of the public sector pay cap, because the Scottish public sector employees are a higher proportion of the total workforce than the UK average, Barnett is not necessarily going to pay for that. A 3 per cent increase across the board on a UK national agreement will cost Scotland more.

There will definitely be budget pressures on public spending in the UK, but they will also affect Scotland, Wales and Northern Ireland to the extent that they have larger public sector workforces. The context of public sector pay will be a very significant issue.

12:00

Professor Bell: I would like to think that I am driven by the evidence. I do not claim to be a trade economist, but all the examinations of patterns of trade show that geography matters—being close to something matters in terms of who you trade with and if you cut yourself off that will be an issue.

On migration, it is important to realise that, for the foreseeable future, the Migration Advisory Committee will play a key role in determining whether we get more anaesthetists, for example, from outside the UK in the future. If Scotland has differentiated needs in respect of particular occupations, it is incumbent on the Scottish Government to make the case to the Migration Advisory Committee that those occupations be placed on its list so that it is easier to get people from outside the UK to fill vacancies. The Migration Advisory Committee currently deals with work for non-EU migrants, but there is a big debate to be had about the change in its role to cover EU migrants after Brexit.

The Convener: We have had a significant session with our two professors this morning. Thank you for helping us to delve deeper into the details of the issues that we will face. That was extremely useful.

12:02

Meeting continued in private until 12:16.

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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