OFFICIAL REPORT
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Finance and Constitution Committee

Wednesday 20 December 2017

Session 5

The Scottish Parliament
Pàrlamaid na h-Alba

Wednesday 20 December 2017

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FINANCE AND CONSTITUTION COMMITTEE

31st 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)
*Emma Harper (South Scotland) (SNP)
*Patrick Harvie (Glasgow) (Green)
*James Kelly (Glasgow) (Lab)
*Ivan McKee (Glasgow Provan) (SNP)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Neil Amner (Scottish Chambers of Commerce)
Russell Gunson (Institute for Public Policy Research Scotland)
John Ireland (Scottish Fiscal Commission)
Dave Moxham (Scottish Trades Union Congress)
Lady Susan Rice (Scottish Fiscal Commission)
Professor Alasdair Smith (Scottish Fiscal Commission)
David Wilson (Scottish Fiscal Commission)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance and Constitution Committee

Wednesday 20 December 2017

[The Convener opened the meeting at 10:01]

Draft Budget 2018-19

The Convener (Bruce Crawford): Good morning and welcome to the 31st meeting in 2017 of the Finance and Constitution Committee. I ask colleagues to remember to put their mobile phones on silent.

Agenda item 1 is evidence on the Scottish Government's draft budget 2018-19. We are joined via videoconference by Lady Susan Rice, who is the chair of the Scottish Fiscal Commission; John Ireland, its chief executive; Professor Alasdair Smith, who is a commissioner; and David Wilson, who is also a commissioner. I welcome all our guests to the meeting and invite Lady Rice to make a brief opening statement.

Lady Susan Rice (Scottish Fiscal Commission): I would like to make a short opening statement and an even shorter closing statement, and I will say something about forecasts in between. Thank you for inviting the commission to give evidence on our forecast report, which we published last—[*Interruption*.]

The Convener: I suspend the meeting for a few minutes.

10:03

Meeting suspended.

10:06

On resuming—

The Convener: Unfortunately, the videolink with Lady Rice has been lost and we do not have time to try to reconnect. This morning's evidence session is quite important, so I am glad that David Wilson, one of the commissioners, is ready to make the opening statement.

David Wilson (Scottish Fiscal Commission): I have a note of what Lady Rice would have said by way of introductory remarks.

Thank you for the opportunity to discuss our report, which was published last Thursday. It is an important milestone for the Scottish Fiscal Commission, as it is our first set of forecasts as an independent statutory body.

We have been set up to provide the official independent forecasts to inform the Scottish budget following the devolution of powers to the Scottish Parliament under the Scotland Act 2012 and the Scotland Act 2016. We are one of a growing number of independent fiscal institutions worldwide, and we work closely with the Office for Budget Responsibility, which is the most prominent such institution in the United Kingdom. I believe that you will see representatives from the OBR in early January.

Our forecasts play an important role in the Scottish budget, which was published on Thursday, alongside our report. The OBR's forecasts also play an important role in that the OBR makes the official forecasts for the United Kingdom Government tax receipts, which are an important part of the block grant adjustment calculation.

As part of the process of developing our report, we worked collaboratively with the OBR, a number of other UK organisations and the Scottish Government. We did that on the basis of our protocol with the Scottish Government and a number of memoranda of understanding that we have with other bodies including the OBR and Her Majesty's Revenue and Customs.

Over the past 10 weeks or so, we have been developing our forecasts. We provided, in good time and ahead of the Government finalising its budget, the final assessment of our forecasts. We also provided, on the basis of information that the Government provided to us, our assessment of the costings of the new policy proposals that the Government announced last Thursday. All the detail of our forecasts and policy costings is set out in our report.

By now, you will have seen and digested the broad numbers that we set out. I will summarise the key points. We made forecasts of around £16 billion of devolved taxes, within which income tax was the most prominent tax. For the first time, we made a set of formal independent forecasts of the Scottish economy. We described the forecasts for the economy as painting a picture of subdued growth over the five-year period. We hope that we have set out quite a detailed level of information to help people to understand those points and develop the wider discussion on them.

Prominent among the policy costings was the detailed costing of the income tax change that the Government announced. We have provided a detailed assessment of the costing and, importantly, of the impact of potential changes in behaviour due to that policy and how those might, in turn, impact on the collection of receipts.

We have set out our estimates of the social security expenditures that have already been devolved, and we are developing our capability to make further estimates of expenditure relating to further powers that are likely to be devolved.

That summarises the report. We will be delighted to offer more detailed answers to any particular questions that members have.

The Convener: Thank you very much. I will ask about a couple of areas in order to get an explanation of some of the numbers on the record. One of those areas is tax revenues and the other relates to gross figures and the fact that the Scottish budget seems to be £366 million better off—we will come on to that.

Table 3.9 in your report includes a forecast of a loss of £51 million in tax revenues for 2018-19 due to behavioural changes out of a total forecast receipt of £215 million from the Scottish Government's proposed tax policy. Can you provide a breakdown of how you arrived at that figure of £51 million? That is probably available in your full report, but it would be useful if you could provide that breakdown for the record.

Professor Alasdair Smith (Scottish Fiscal Commission): The main thing about the breakdown of the behavioural response is that almost all the behavioural response happens at the top end of the income scale.

David Wilson: The main impact is set out in annex A of the report. That is the more detailed assessment of the policy costing of the change in income tax. In developing that assessment, we produced what we call a static costing—the costing of the proposal without any behavioural impact—which assumes that people's tax liabilities would stay the same, the amount of work that they declare would be broadly similar and the new tax rate would apply to that same amount. The detail, broken down using the new five-band approach, is in table A.6, on page 194 of the report. Table A.7, on the following page, sets out how the behavioural effect would break down by tax rate. As Alasdair Smith said, the overwhelming majority of the behavioural impact would be in the top two groupings: the higher rate and the top rate. That is set out in table A.7.

The Convener: The static costing for the top rate is set at £53 million. That is an improvement in terms of tax take but, as a result of behavioural issues, that figure will be reduced by £31 million. Can you explain how you came to those numbers?

John Ireland (Scottish Fiscal Commission): Yes. To calculate that £31 million reduction at the top rate, we developed what we call taxable income elasticities, which are basically factors that allow us to look at the impact of the changing tax rates on top-rate payers. Those factors are taken from a series of studies at the UK level that were done by HMRC and that have been looked at by the Institute for Fiscal Studies. Those studies have produced a range of factors. Our factors are very much towards the top end of that range, because the HMRC and IFS numbers were calculated in response to a UK-wide change in the top rate and we are very conscious that, if the change happens only in Scotland, the opportunity for people to rearrange their affairs between Scotland and the rest of the UK is much stronger. That is why we have gone for something at the top end of that range.

The Convener: I know that you have probably not calculated these numbers, but, if the numbers at the top end are correct, that suggests that if there was, for instance, a 47 per cent rate, the tax take from top-rate taxpayers would begin to turn negative. Am I right?

10:15

John Ireland: We have looked only at the actual proposal that the Government has made, which is for a 1p change in the rate. In a sense, that is all that our remit allows us to do, so we cannot talk about alternative policies.

The Convener: Okay.

Adam Tomkins (Glasgow) (Con): I understand that. However, if there were a 2p change in the top rate, rather than a 1p change, would the behavioural change be likely to double? We have no idea how those numbers are calculated.

Professor Smith: We would expect both numbers to grow. The static revenue raised from a 2p rate rather than a 1p rate would be higher and the behavioural effects would be greater. As John Ireland said, we have not done any analysis of that, but there is no reason to suppose that the behavioural effect would grow faster than the direct revenue effect, so the tax take would not necessarily turn negative.

John Ireland: There is one more thing to add. Our modelling has allowed us to think about forestalling effects as well, and we judged that, for the rise that the Government has decided on, there are no real measurable forestalling effects. However, for larger tax rate changes there might well be forestalling effects that would have an effect on the estimates. We make that clear in the report.

The Convener: Does anyone else want to ask about the figure of £51 million? Ash, do you want to ask about that, or have I used up all of your question?

Ash Denham (Edinburgh Eastern) (SNP): I think that you have covered it, convener.

Patrick Harvie (Glasgow) (Green): You acknowledge in the paragraph just below the tables on page 195 of your report:

> "The key uncertainty in the costing is the taxpayer behavioural response."

We are looking at a guesstimate—something that involves significant uncertainty. Would you say that you have erred on the side of caution?

Professor Smith: You are right in saying that it is an estimate. As John Ireland explained, it is based on a body of work that has been done by HMRC and others, but it is an estimate nevertheless.

No, we have not aimed to err on the side of caution; we have aimed to give our best estimate. That is our job.

Patrick Harvie: No one would expect you to have a crystal ball that allows you to predict with 100 per cent certainty, so there will naturally be some uncertainty, but the consequences of a significant variation between this prediction and what actually happens are not just financial but political as well. They could profoundly affect the nature of the debate at the next Scottish Parliament election, for example, if the Scottish Government at that time has to deal with significantly less money being available because the behavioural effects were underestimated or with significantly more money being available because the behavioural effects were overestimated. Have you thought about how to minimise the political risks of that uncertainty?

David Wilson: Our aim has been to develop the most robust estimate that we can, recognising the significant uncertainty that exists. An important report that was undertaken by HMRC evaluated the UK Government's experience of the increase in the top tax rate in 2010. On the basis of actual data and evidence of a real-life experience, it was found that the uncertainty about the overall effects of behavioural change meant that they were still difficult to assess.

I repeat what my colleagues have said. We have made an estimate that draws on the best available information and analysis, recognising that we are in new territory and that we do not have accumulated experience of how differences might play out when people within a single nation state can adjust their tax affairs between being a Scottish taxpayer and being a UK taxpayer. We have made an informed judgment and we have set out all the details in full.

Patrick Harvie: A number of other countries and states, both in Europe and in the US, have different income tax rates and bands in different tax jurisdictions. There should be some real-world objective information about how likely people are to take such decisions as a result of modest variations such as these or significant variations.

Have you looked at that objective data, and do you have a clear basis for assuming what level of relocation, for example, would take place at the high end of the income scale? We are not talking about people who are mobile and at the start of their career; we are talking about people who have put down roots, built up a network that is important to their career and invested in their home. How mobile are people? Surely, we must have some answer to that question?

David Wilson: We have looked at the evidence of that, and that has been core to the work that HMRC and the Institute for Fiscal Studies have done. They have looked at the experience in America and the difference in tax rates between states. There is a body of knowledge and understanding of that.

Nevertheless, we should be careful about thinking that that will give us a definitive answer. We have had to make judgments and have tried to address some of the points that you have made. Broadly speaking, the recommendation that the Institute for Fiscal Studies made is to use an elasticity of 0.48, which is slightly different from what we have done. We deliberately used an elasticity such that the impact on the very highest taxpayers is greater than on those earning between £150,000 and £300,000.

It is a question of judgment, but we think that it is a good judgment that reflects the particular circumstances in the UK under the current structures, whereby people can choose to declare their taxable income in different places if they have multiple household locations. There are flexibilities in it, but we have made our best judgment on the basis of the informed evidence.

Patrick Harvie: You are not making a prediction about the amount of relocation that there will be.

David Wilson: We are not making a specific forecast on relocation; we are making an overall assessment of the impact. We are not setting out particular numbers for the impact of relocation or any other effect.

Professor Smith: I have one point to make about relocation. When making a comparison such as this, you need to think not just about the incentives for people who are currently in Scotland to relocate so as to reduce their tax bill but about people in the future having a choice about where to establish their main residence. A significant tax difference might affect decisions to locate rather than decisions to relocate.

Patrick Harvie: Clearly, that is a long-term consideration rather than one for 2018-19. We will all have to take responsibility for thinking about what motivates people. Is it simply the amount of tax that they pay or is it something wider about the kind of society that they want to live in?

The last thing that I want to ask about is the other main behavioural effect that you draw attention to, which is tax-motivated incorporation—people moving from being employed to being self-employed for tax purposes. Have you taken a view about the extent to which that is a genuine move by people from an employed job that they are in into self-employment and the extent to which it is bogus self-employment, with employers paying their employees as though they are self-employed for tax reasons?

David Wilson: We have not made any analysis of the labour market in that particular way. That would probably be beyond our remit. We have taken advice from HMRC on its expectations of tax-motivated incorporation, which would be both a UK and a Scotland-wide effect. We have largely used HMRC's estimates for tax-motivated incorporation; we have not done a more detailed assessment such as you have described.

Patrick Harvie: What proportion of the behavioural effect will be due to incorporation?

David Wilson: We have two separate estimates for that. Overall tax-motivated incorporation will impact on all groups and will apply irrespective of any change in tax. We make a separate estimate of the elasticity of the change in tax. Changes in incorporation are happening across the UK, including in Scotland, as a result of both the labour market and overall tax policy. There are two separate things, in our estimation.

Patrick Harvie: You cannot tell us what proportion of the behavioural effect, which you say will be £51 million, will be due to incorporation.

David Wilson: We have made a single estimate of the overall elasticity and impact, which is the figure of £51 million. We have not decomposed that into effects from incorporation, relocation and change in status—there is one single overall estimate. There is a separate estimate of tax-motivated incorporation affecting all taxpayers in the report.

John Ireland: The increasing number of tax-motivated incorporations will reduce income tax revenues in Scotland by around £240 million in the next financial year.

James Kelly (Glasgow) (Lab): The elasticity rate that you used was mentioned in one of the answers. The standard rate was 0.48, but you used a higher rate. What rate was used?

David Wilson: Broadly speaking, elasticity would be negligible to low at the very low end of tax. For starter-rate and basic-rate taxpayers, we would expect elasticity of around zero. We used a figure just above that. For £150,000 to £300,000 we used 0.35, for £300,000 to £500,000 we used 0.55, and for above £500,000 we used 0.75. I know that, in the Scottish Government's latest estimates—its medium-responsive estimates—it uses 0.48 throughout. It does not use the variability that we use.

James Kelly: Okay.

In your answer to Patrick Harvie, you acknowledged that there are different sources of evidence in respect of behavioural changes. How did you weight the various evidence that you looked at in order to build the assumptions for your model?

Professor Smith: That is a matter of pure judgment. As both my colleagues have explained, we have evidence—in particular, evidence that is built into the HMRC model. On how we use that in the particular circumstances of Scotland, there is reason to suppose that upper-rate taxpayers might be relatively mobile between Scotland and the rest of the United Kingdom, so the level of elasticity to apply to them is a matter of judgment.

Ivan McKee (Glasgow Provan) (SNP): I am looking at table 3.10 in "Scotland's Economic and Fiscal Forecasts December 2017", in which those numbers are laid out. First, I have a technical question. What is the difference between intensive elasticity and extensive elasticity?

John Ireland: Basically, intensive elasticity is concerned with the hours that are worked and extensive elasticity is concerned with the decision to participate in the labour market or to move residence. As we said earlier, that work is based on HMRC modelling, and HMRC initially looked at changes in the UK additional rate. That is intensive elasticity. When there are lots of changes in the allowances that also apply in Scotland, it introduces extensive elasticity.

Ivan McKee: Right. So you used intensive elasticity. You have just quoted the numbers to James Kelly.

John Ireland: David Wilson gave the intensive elasticity. There is an extensive elasticity of 0.25 throughout from £150,000 upwards.

Ivan McKee: Do you know what the blended—the weighted average—number is on those intensive elasticities when we take into account all the different income bands that you have talked about, so that we get a comparable number against the 0.48? Does that make sense?

John Ireland: I do not know that off the top of my head.

Professor Smith: We would have to get back to the committee on that.

Ivan McKee: That is fine.

My last question is probably the hardest one. Is it your remit to come back after the fact and give us what you think the outturn has been in respect of elasticity, taking into account the complexities around counterfactuals and forestalling? How difficult would that be? Would you be able to do it?

10:30

Professor Smith: It is a very important part of our remit to look back on how our forecasts have performed and to produce forecast evaluation reports. The report that we produced a few months ago was an evaluation of the Scottish Government's forecasts, and our future reports will be evaluations of our own forecasts. We will consider all the forecasts, which involve quite complex judgments, and judge whether we got them right.

Ivan McKee: So you will give us a number. You will say whether that 0.75 was high, low or right.

Professor Smith: Yes—but it has to be said that, looking back at what has happened to tax revenue, and trying to extract from future Scottish tax revenue how much of the tax revenue change was due to behavioural effects or forestalling effects, is not a simple matter. We will do our best to evaluate what we have done.

Ivan McKee: Good luck.

David Wilson: We will certainly need to do that work. We would very much like to do the sort of analysis that HMRC undertook for the 2010 tax change. Evaluating impacts is an important part of our remit.

However, I will sound two notes of caution. The first is that data at UK level would probably be better than data at Scotland level and, even with better data, it is difficult to draw out the detail of the effects. The second is that it will probably take us a bit longer to do that assessment because we will not get detailed information through the various sample surveys for two to three years. That means that we will not be able to do the work in the sort of timescale that we would all want.

John Ireland: It is important to add that we do not get income tax revenue data for 18 months. We are talking about there being two years before we will have a real idea of the situation, although we will start to look in September next year.

The Convener: You have relied on the HMRC model and, to some extent, the IFS work that has been done. Does that HMRC model confine itself to issues to do with tax movement, or does it also explore wider issues to do with council tax, water rates and the policy choices of different Governments and the effect that they would have on tax?

John Ireland: My understanding is that the model is based on income tax only, but we can clarify that for you.

The Convener: Perhaps as the situation develops, those issues should become part of the model, if they are not already. That is something that the Fiscal Commission could think about later—the issue involves judgment not only of how much money is in someone's pocket at a given moment, but of the other factors surrounding that.

A number of people are interested in growth forecasts. Your growth forecasts for Scotland are more pessimistic than the OBR's forecasts for the UK. However, the Scottish budget document—in figure 2.12, I think—-says that the Scottish budget will be better off by £366 million in 2018-19 than would have been the case without fiscal devolution. Can you explain that for us?

Professor Smith: Are you asking us to explain the difference between our growth forecasts and those of the OBR?

The Convener: I would like a bit of that but, more important, if it is the case that we will have slower growth, how will we have £366 million more to spend?

Professor Smith: Do you want to have a go at that, John?

John Ireland: The £366 million figure comes from the difference between our forecast of the income tax revenue and the block grant adjustment. That involves a number of factors. Our income tax forecast includes the higher-rate threshold in the draft budget for 2017-18. That represents roughly £60 million in 2018-19. It also includes the impact of announced draft budget 2018-19 changes, which are expected to be about £160 million. That leaves about £150 million, which is due to a number of technical modelling differences between our model and the OBR's. One factor that is particularly important is that our forecast includes higher public sector pay growth than the OBR's does.

The Convener: Those are the three elements that make up that £366 million. It is useful to have that on the record.

Neil Bibby (West Scotland) (Lab): You are forecasting an impact of £60 million on income tax as a result of public sector wages increasing. I understand that you have an assumption that public sector wages will grow by 3 per cent. In the budget last week, the Cabinet Secretary for Finance and the Constitution said that people earning £30,000 per annum or less will have their wages increased by 3 per cent, and those who earn above that will have them increased by 2 per cent. There may be other factors that you have included in that assumption, but I want to clarify how you got to the 3 per cent figure.

Professor Smith: When we look at what happens to any public sector pay bill, it is not just the headline pay increase number that goes into it. There are other factors, such as pay drift, that mean that the overall increase in the pay bill is different. In this case, it is higher than the average increase and the headline pay increase.

John Ireland: As well as that, there is the fact that the public sector policy that we were given by the Government will, in its strictest sense, apply to only about half of public sector workers in Scotland. We therefore made assumptions about the remainder of them, and we stuck that at a lower level. I also clarify that our 2018-19 assumption on the average public sector pay growth is 3.2 per cent.

Neil Bibby: You have made assumptions about average pay. What assumptions have you made about the number of public sector jobs?

John Ireland: There are about 470,000 workers in the public sector in Scotland. We estimate that the policy applies to approximately 260,000 full-time equivalent workers.

The Convener: We will move on to growth, in which a number of members are interested. I probably nicked some of Ash Denham's questions at the beginning of the last session, so perhaps she would like to ask the first question on growth, then we will come to Adam Tomkins and Ivan McKee.

Ash Denham: Good morning. I want to ask about your economic growth rate prediction. With regard to the relationship between the UK and the European Union, you say in your report that the negotiation

"will impact negatively on the Scottish economy"

over the next few years, due to matters such as trading arrangements and reduced migration into Scotland, which will have a slowing effect. I am interested in whether it is possible to isolate the effects of Brexit so that you can say what proportion of the lowering of the prediction on the Scottish economy can be attributed to such effects, which are obviously not under the control of the Scottish Government?

Professor Smith: No—we have not done a modelling exercise without Brexit to isolate its effects. The Brexit effect will come in and is an important element in our overall judgment of the likely level of economic growth. Ash Denham has rightly identified that things that have gone into the judgment about the effect of Brexit include uncertainty about the policy regime, probable reductions in trade in both directions and reductions in migration. However, that is part of our overall judgment of future growth, rather than being an element that can be separated out, and of which we can say that X is the Brexit effect. It will have a net negative effect—we have made it clear that we think that it will be significantly negative—but we have not done that in a way that gives a separate number for Brexit.

Ash Denham: Are you able to put figures on the three elements that you mentioned—migration, trade and policy—or to say what proportion each might have within that negative effect?

Professor Smith: We can do so only in respect of some of the migration effect, in that our overall forecasts include a population projection. We have chosen to use a population projection that has a 50 per cent reduction in EU migration in both directions. That element is separately identifiable, although I could not put a straight number on it for you. However, the rest is all folded into our overall judgment about economic growth.

Ash Denham: Do you think that the gloominess of the prediction could become a self-fulfilling prophecy? What I mean is that if you predict enough times that something will happen, the situation is then gloomy enough that it begins to have a dampening effect.

Professor Smith: People can look themselves at the data that has influenced our judgment. What has influenced our judgment is several years of subdued growth in the Scottish and UK economies. That period of slow growth is now so extended that our view, sadly, is that it is sensible to expect it to continue. However, I do not think that our forecast itself will have a markedly negative effect on people's expectations—after all, as I have said, the things that have fed into it are there for us all to see. Businesses thinking about their prospects for their future will look at how business has grown in the recent past instead of, as I would like them to do, looking at forecasts in great detail. Their experience of slow growth over the past seven or eight years, rather than our forecast, will influence their expectations.

Adam Tomkins: We have talked a little about why your growth forecasts for Scotland are more pessimistic than the OBR's forecasts for the UK. In fact, your forecasts seem to be more pessimistic than any other published forecast of growth in the Scottish economy. You are more pessimistic than the Fraser of Allander institute, EY and—if I have it right—PricewaterhouseCoopers. What causes you to be more pessimistic about Scottish economic growth than those other forecasters of the Scottish economy?

David Wilson: I will make two points to begin with.

The key point that we try to draw out in our report is that the subdued growth that we are forecasting over the next five years probably has two key factors, the first of which is much more moderate productivity growth than we might have been used to in the past few years. Figure 5 on page 12 of the summary document very graphically sets out the world that we are in, in which things are actually very different from the expectations that formed in people's minds in the 1990s and early this century of our having very significant productivity growth.

The second key factor is, as Alasdair Smith has pointed out, population. Given the strength of the labour market in Scotland and the fact that we have very high employment and very low unemployment, any increased growth is going to have to come from boosting productivity. Of course, this is not a Scotland-specific issue; we are in a world environment in which it is increasingly hard to improve productivity, and we have tried to take that into account in the forecasts.

A crucial point that might not have come through in all the commentary is that although our forecasts for productivity in Scotland might be slightly less than the OBR's forecasts, they are not significantly out of line with them. The overall difference between our projections and the OBR's lies not in the productivity assessment but in the other factors. I would not say that we are in any way out of line with the OBR's assessment of productivity, but in Scotland a number of factors have helped to boost the economy over the past few years. I am thinking in particular of the period pre-2014 and of the oil and gas sector. We are not convinced that a number of elements in the economy that have been keeping growth relatively strong in difficult circumstances will continue to do so. We are facing not only a worldwide and UK-wide set of challenges around productivity, but particular Scottish circumstances, and all that is pointing to the results that we have set out.

I also remind the committee that they are our first forecasts, and that it is the first time that we have had official forecasts for a five-year period. It is very positive that the Fraser of Allander institute now does forecasts out to 2020. As part of our remit, we have had to make judgments over a long time period using the best modelling that we have available, and those are the numbers that have come through that systematic assessment.

10:45

Adam Tomkins: That is helpful.

It is not just Scottish gross domestic product growth that is forecast to be what you call "subdued"—which I think is putting it politely—but Scottish GDP per capita growth. The per capita figures are in all sorts of ways just as important and even more stark than the overall growth figures. What is your account of why GDP per capita growth in Scotland is forecast to be so poor?

Professor Smith: In looking at figures for long-term growth, we all have to recognise that there is a bit of a puzzle about productivity. As David Wilson said, low productivity levels are something of a worldwide phenomenon. There are different views about why productivity has slowed down, and the Fiscal Commission will not resolve that great debate about the origins of the productivity slowdown. Our judgment is based on observing what has happened in the past. Productivity in the Scottish economy, which is the main driver of per capita income, has been "subdued", as we say, for a number of years now. Although we do not offer a theory as to why that is, as realists, we have to suppose that that experience will continue into the future.

John Ireland: Just to give a sense of exactly what the differences are on GDP per capita growth, figure 3 in the summary report shows that, basically, there is a narrowing gap between GDP per capita growth in Scotland and that in the UK, and that they come together by the end of our forecast period. Therefore, the differences at GDP level are primarily due to demographic differences. Mr Tomkins used the word "subdued", and it is true that our GDP per capita forecast is subdued, but it closes to the OBR's UK forecast at the end of the period.

Adam Tomkins: Other members want to ask about productivity, so I shall leave that, important though it is.

One of the documents that was published with the budget last week was the "Scotland Performs Update". One of the measurements that caught my eye in that document and that does not appear in the draft budget document or in the Fiscal Commission report is a comparison of Scotland's GDP growth rate with that of what are described as "the Small EU Countries". In the Scottish Government's analysis, performance in that regard is worsening under the Government's watch. We have a lower GDP growth rate than the small EU countries, and have had ever since the third quarter of 2015. Do you have any reflections on whether that is a valuable performance measurement for us to take more seriously than perhaps we have done hitherto, or on what the reasons for the performance might be?

Professor Smith: It is certainly an interesting comparison. I am not sure that I have seen the exact comparison to which you refer, but there have been comparisons between growth in the UK and growth in the rest of the EU. Scotland is not alone in having subdued growth performance relative to other small EU countries. The UK's growth performance in recent years has been low compared with that of most of the rest of the EU. The Scottish comparison is relevant, but it might be driven largely by a UK comparison with the rest of Europe.

Ivan McKee: I hate to say it, but surely one of the reasons for Scotland's performance compared to that of other small independent European countries is that we do not have control of all the levers to manage the economy.

Professor Smith: That is a political judgment that is not within our remit to pronounce on. You will all have your own views on that, and, even if we were to step outside our remit and pronounce on those matters, I doubt that we would shift any views round this table.

Ivan McKee: Yes, but it is a fairly obvious conclusion. I will not waste everyone's time by listing all the levers that we do not currently have control of but which we would have control of if we were independent.

You talked about your assessment that the Scottish economy is currently over capacity. I want to explore a couple of issues in that regard. You said that your population model, which uses the Office for National Statistics model, is different from that of the OBR. You used the 50 per cent net migration variant. How different is the OBR's model? If you had used the assumptions that the OBR is using to project UK population growth vis-à-vis Brexit when you considered Scotland's population growth, how much difference would that have made to your forecasts?

David Wilson: Let me answer that in two stages. First, on the point about output gap, let me draw out the people dimension in all of this. It is striking that people have seen the overall growth numbers in our report as some sort of downgrading, but it is important to compare our forecasts with the Scottish Government's forecasts at the start of the year. We are forecasting significantly lower unemployment than the Government forecasted, and we are forecasting employment that is quite a bit higher—although I would not say that it is significantly higher—than the Government forecasted. That tells you something about the nature of the economy and about the particular circumstances that we face, in that there is a tighter labour market than people were expecting.

On population, for the overall UK forecast the OBR used the principal projections that are made by the ONS—it is important to emphasise that they are projections, rather than forecasts; we could go into the fine detail on that, if we needed to. We could have used the principal projections for Scotland in our modelling, but we chose to use a lower forecast, because we are concerned about the potential impact of Brexit and because our overall assessment is that issues to do with migration are a key element and an area of concern.

Our assumptions have probably not had a significant impact on the overall numbers at an early stage. Let me draw out the detail on that. The key element of population projections is not so much births and deaths, which are fairly straightforward to project, but net migration. In Scotland we have gone from having net out-migration 20-or-so years ago to having fairly significant net in-migration more recently, and the expert view in advising on forecasts is that in-migration is around 15,000 a year—it has been a bit higher over the past couple of years, but that is the benchmark. The implication of the assumption that we used is the difference between 15,000 and 12,000, which does not make a significant difference in terms of the overall numbers, but we are moving in that direction, given the circumstances that we are in, and we are very committed to monitoring the situation.

John Ireland: We have done some sensitivity analysis of our macro forecast; the results are in the full report, in table 2.8. There is a migration variant, in which we used the ONS principal projection, which produced a growth rate of 0.9 per cent on average over the five-year forecast for GDP, compared with our forecast, which was an average growth rate of 0.8 per cent. As David Wilson said, the difference is quite small.

Ivan McKee: Thank you.

Professor Smith: May I go back to the point about the output gap? I appreciate that many of you do not have the full report in front of you, but I draw your attention to figure 2.12, on page 67, which looks at the relationship between actual GDP and potential output and shows a big negative output gap in the years immediately following 2008.

The output gap in the current numbers is so small that it is not visible in the graph. Therefore, when we talk about our forecast being based on a positive output gap, we are talking about a very small positive output gap; the OBR has a very small negative output gap.

We and the OBR are forecasting that the labour market is in a tight situation, but the gap between the potential output and the actual output is very small in both our modelling efforts. In a way, it would be more accurate to say that we have focused on an output gap that is very small, rather than focused on whether that is positive or negative.

Ivan McKee: That is clear. Notwithstanding that, that is still a constraint on economic growth.

Professor Smith: Yes.

Ivan McKee: In that scenario, any policy measures that boost the labour supply are critical. How much cognisance have you taken of measures that focus on, for example, childcare, skills and training and employability programmes? Does focusing on those areas increase labour supply and help to increase growth?

Professor Smith: Such a focus has certainly contributed to growth in the past. The figure on the components of growth over time to which David Wilson referred shows that increased labour force participation has played a significant role in past growth.

We are not forecasting that there will be significant effects on labour force participation in the immediate future. If there were, that factor would push us towards higher growth.

Ivan McKee: For example, if, as is planned, the childcare policy steps up a gear, a lot of people who are staying at home would be freed up to join the labour market, which could have a significant impact.

Professor Smith: It could. It is important to emphasise that when we do not seem to be taking explicit account in our forecasts of such policies—or pro-business policies, in the area of non-domestic rates—that is not because we think that they have no effect; rather, it is because, in the timescale that we are looking at, we are looking for firm evidence of what the effect is on the overall economy. We would have to get evidence of what the concrete effect might be before we would have the confidence to feed that into the forecasts. The fact that we are not forecasting an increase in participation does not mean that we do not think that a successful childcare policy might have a significant effect on growth.

Alexander Burnett (Aberdeenshire West) (Con): I will stick to the topic of productivity, the labour supply and migration. What impact does expanding the economy by attracting low-paid and low-skilled workers have on productivity measures?

David Wilson: That gets us into a wider set of questions. Alasdair Smith described the issue of trying to understand and explain the nature of the economy at the moment. We have seen a very strong performance in terms of overall employment and the creation of jobs, which is perhaps even more pronounced at the UK level, but we have also seen almost an opposite effect on overall productivity. We have tried to draw out the implications of that in our assessment.

As you rightly say, if the labour supply were to significantly increase, if we had more people working or if the hours worked by people in the labour market were to increase, that might, in one sense, boost GDP, but we would expect that to lead to a reduction in productivity, which could counteract the boost. Those are the sorts of issues that we would look to model.

Alexander Burnett: If, as you have alluded to, we are operating at overcapacity, an important point is that this is not just about creating jobs, but about creating the right level of jobs.

David Wilson: Absolutely.

Alexander Burnett: Is there a salary point where the creation of a job has a positive effect on productivity, as opposed to otherwise?

Professor Smith: It is not a matter of looking at a salary point. As David Wilson said, the general pattern in the UK in recent years has been of healthy growth in the overall employment numbers, but having a more flexible labour market has led to the growth of low productivity in employment.

Alexander Burnett: That would still work in the rest of the UK, which is operating at undercapacity. However, in Scotland, we are operating at overcapacity, and it is not just about jobs.

Professor Smith: As I said a moment ago, the difference between over and undercapacity in Scotland and the rest of the UK is really small. It is better to think that, on best estimates of where we are across the UK, unemployment is at historically low standards. Therefore, the whole UK economy might be judged to be at or just about at capacity.

11:00

Alexander Burnett: We are hoping to see an increase in public sector pay, but without any improvement in outputs. How does that contribute to declining productivity?

Professor Smith: Looking at productivity in public services—and indeed, to some extent, in services generally—is quite a difficult thing to do and we have not addressed it in the report.

The Convener: We move on to the land and buildings transaction tax.

Willie Coffey (Kilmarnock and Irvine Valley) (SNP): Your forecasts on LBTT are quite buoyant compared with last year. Can you give us a bit of background on that? What are the main factors driving that? Is it something to do with the change in the first-time buyer policy or are other factors giving rise to that more buoyant estimate?

Professor Smith: Our buoyant estimate, like many of our other estimates, is based on recent experience—by recent historical standards, there has been quite a high level of transactions and price increases in the residential market. We are projecting that that will continue.

David Wilson: We have not returned to the sort of levels that we had in the pre-financial crash situation, but there has certainly been a substantial recovery in both the level of transactions and overall house prices.

The emerging evidence, particularly this year, is that there has been an increase in prices in particular, which was not fully anticipated. We expect that trend to continue, certainly for the rest of this year and perhaps into the start of next year. We then estimate more of a reversion to what we are describing not quite as the new normal, which is a term that is being kicked around at the moment—the housing market is certainly not going back to pre-2008 levels but it is doing well, with house prices increasing, perhaps particularly at the upper end of the market, and that is set to continue in the near term. That is the principal factor that explains the increase in the overall estimate.

The "pre-measures forecast", as we describe it, has increased quite significantly from what was anticipated last year. The first-time buyers relief that the Government has announced is separately modelled. It will lead to a reduction of the order of £5 million or £6 million in what our forecast would otherwise have been.

Willie Coffey: But you are predicting that there may be up to 200 extra transactions as a result of the first-time buyers policy—how did you arrive at that figure, if you do not mind me asking? Is there some kind of secret calculation in there that you can share with us?

Professor Smith: It is another of those elasticities. That estimate is in line with work that the OBR has done on the effects of changes in stamp duty or land tax in England and Wales. It is based on one of those elasticities, as I said.

Willie Coffey: It is based on established models elsewhere, then.

The policy costs £6 million to deliver. Do you think that overall, the revenue that is raised through LBTT will still increase?

David Wilson: Yes. The increase is substantially greater than £6 million. A significant number of transactions will be affected by the change. Broadly, we estimate that about 12,000 transactions will be affected. Our estimate is more about how the policy will impact first-time buyers compared with other buyers who are in the market.

There will be a reduction but there is a risk that, rather than the first-time buyers seeing that as a personal saving, it becomes a further contribution to pushing up house prices. There will be beneficiaries, but the question of whether those beneficiaries will be the first-time buyers themselves needs to be taken into account. It may well be the seller rather than the buyer who benefits.

The Convener: We move on to another area—block grant adjustment.

Murdo Fraser (Mid Scotland and Fife) (Con): I want to explore a bit more the issue of the connections between your projections on economic growth and productivity and the impact of that on tax revenue and the Scottish block grant.

Your forecast assumes that productivity growth will be much lower in Scotland than in the UK as a whole and you project much lower economic growth in Scotland than in the rest of the UK. However, you seem to suggest that earnings growth and therefore income tax revenues in Scotland will be roughly equivalent to RUK levels. Why do you draw that conclusion from the input data?

Professor Smith: Why do we conclude that Scottish income tax will grow more than the block grant adjustment?

Murdo Fraser: Yes.

Professor Smith: The block grant adjustment is based on a calculation of what is happening to tax receipts at the per capita level. As we have discussed, at a per capita level there is a gap between our projections and the OBR projections, but it is not as big as the gap in actual GDP growth. The effect of a small difference in our growth rate assumption is basically overridden by the fact that last year, and again this year, Scotland is introducing revenue-raising income tax changes that raise income tax above the level that it would have been had Scotland stuck with the UK income tax rate. That is the factor that is primarily driving the difference between our income tax projections and the block grant adjustment figure.

Murdo Fraser: Figure 9 in your summary paper compares your income tax forecast with a previous forecast in February 2017. There is quite a large gap—I think that it amounts to £2.1 billion over the next four years—between what was previously forecast and what you are now forecasting. What impact is that gap likely to have on the level of the Scottish block grant, or is it not possible to say at this stage?

Professor Smith: The block grant adjustment depends on OBR projections of UK growth, and those projections are being revised down as well. I do not think that there are any significant implications for the block grant from this change, because it is a change that the OBR is making as well.

David Wilson: That is the important point.

Just to clarify, the difference that you identified is between our forecasts now and the Scottish Government's forecasts for the year. The broad magnitude of the change in the forecasts is very similar—it is actually a bit less—than the change in the OBR's forecasts from last year to this year. That is part of the overall picture of the way in which the forecasts have changed.

On the block grant adjustment, the critical numbers are the baseline number, which is the 2015-16 estimate of income tax revenue, and then the number uprated by the growth in UK taxes. Those are the two key numbers, if you like. The calculation of the block grant adjustment that has been put in place for this budget uses our forecast of the 2015-16 budget. That is still a forecast for 2015-16, because we will not get the outturn—the actual numbers—until the summer next year. In future, the block grant adjustment will be calculated based on those actual outturns. Those are the critical numbers going forward, rather than the difference between Scottish Government forecasts and our forecasts.

Ivan McKee: To clarify, is it fair to say that it is not sensible to compare those two numbers, because they are starting from different baselines?

David Wilson: Do you mean the Scottish Government's numbers and ours?

Ivan McKee: Yes.

David Wilson: It is part of developing an overall picture and understanding of how things have changed. The numbers tell us other things, but they do not advise us much about the calculation of the block grant adjustment.

Ivan McKee: So it does not say something about the impact of the policies or anything like that. The arithmetic has calculated those numbers in that way because you have taken a different view on the baseline for 2015-16; they are not a consequence of policy decisions as such.

David Wilson: Table 3.6 sets out a very detailed assessment, which decomposes how we got to our numbers, as compared with the Scottish Government forecast. Comparing current forecasts with what was done a year ago is a valuable exercise, but I repeat that the number mentioned—about £2 billion of cumulative difference, based on the comparison between our forecasts and the Scottish Government forecasts—is slightly greater than the difference between the two OBR forecasts. If we look at UK estimates, the difference between the OBR's estimated forecasts now compared with what it said a year ago is about £20 billion. That is how far we have moved in terms of our overall assessment of forecasts of income tax in Scotland, but also in the UK.

Ivan McKee: That is clear. There is not something specifically Scottish about that difference.

David Wilson: There are Scottish elements in the detail, but the broad picture of the impact of downgrading of productivity assumptions is relevant to the UK as well as Scotland.

Ivan McKee: Thank you.

The Convener: Emma Harper wants to cover some areas on pay.

Emma Harper (South Scotland) (SNP): Good morning, everybody. I am interested in the information about carers allowance and the fact that it is forecast to increase over the next few years, with case load and weekly rate increasing in line with consumer prices index inflation. I am interested in your views about the significant numbers of women who are carers and nurses. About 89 per cent of nurses are women, and the mid-range salary band 5 level will benefit from the budget proposals. What are your thoughts or views about the 70,000-odd women who are carers and nurses who will benefit from the proposals?

Professor Smith: Our focus has been on forecasting the likely cost of the carers allowance; we have not gone into detail on the breakdown of the people who will receive it. We are not making an analysis of the policy as such.

Emma Harper: I should remind everyone that I am a nurse, and 18 months ago I was one of those band 6s who will benefit if the draft budget is approved.

John Ireland: You are talking about the Government's pay policy—the benefit from it and its impact on our forecast of the carers allowance. We did not make that connection. We received the Government's pay policy information very late in our forecasting round, so we have not taken explicit account of that policy change in our carers allowance forecast.

Emma Harper: Carers allowance will be increased to match the rate of jobseekers allowance, so ultimately we will have challenges with that. We spoke about the workforce, and others have mentioned the 3 and 2 per cent pay rises. Is there likely to be an increase in the input required to support the need for further carers allowance as our population grows older?

The Convener: I am not sure whether that is something that the commission would look at under its remit. Is it?

Professor Smith: No. That is a matter for the Government and not for us.

11:15

David Wilson: As John Ireland said, your initial question, which was about identifying whether the pay policy had an impact on the modelling that we developed, is a valuable one. We did not take the pay policy into account, and we might well need to look at those numbers and try to make the assessment that you have suggested. We can come back to you on that.

I make it clear that evaluating different policies and different needs and making recommendations to the Government on how those policies might change carers allowance is not a task for us, but we are keen to monitor the implications of the pay policy and to understand how it will affect the detail of the numbers. Perhaps we can get back to you on that.

The Convener: I am glad that Emma Harper pulled that out. It is interesting that you said that you got the information about pay too late to build it into your assumptions. Could you provide us with a bit more detail on that in the timescales that are involved?

John Ireland: We can be very clear about how the information on the public sector pay policy fed into our forecasts. In summary, it fed into our income tax forecasts, because we had the time to do that work, but it did not feed in anywhere else.

We certainly intend to talk to the Government about when we get details on pay policy. The earlier in the forecasting round that we get a sense of those details, the more work we can do to look at the question that Emma Harper raised. This time, we did our forecast on the basis of the best information that we had available at the time.

Patrick Harvie: You said that you have had time to look at the impact that the proposed pay policy will have on income tax. Is that impact significant?

John Ireland: It is. I think that we have a breakdown of the impact of the pay policy on income tax. I cannot lay my hands on it at the moment, but we can certainly let you know about that.

Patrick Harvie: If it is in the full document, I will dig it out, but I did not see it when I looked through it.

John Ireland: I am pretty sure that it is in the full document.

David Wilson: I have a brief point to make about that. When we say that we received the information too late, I mean that we received it too late to enable us to do a proper assessment, not that the Government did not give us the information broadly in line with the timescales that are set out in the protocol. In that sense, it was not late.

As further consideration of the budget proceeds in January, we will be happy to make a further assessment, if that would be useful.

The Convener: The last question is on air departure tax.

Neil Bibby: You forecast revenues of £306 million for ADT in 2018-19, but the Scottish Government's financial memorandum to the Air Departure Tax (Scotland) Bill forecast revenues of £326 million in 2018-19. You forecast that revenues will rise to £336 million by 2021-22, whereas the financial memorandum forecast that they would rise to £378 million by 2021-22.

You rightly point out in your summary document that there has been an increase in Scottish passenger numbers and that you expect revenues to increase over the five-year period. Why is there a difference between the two sets of forecasts?

John Ireland: I do not have the answer to that. We can certainly look into that.

The Convener: Thank you very much. I am grateful for your attendance. It just remains for me to thank you for being here. We wish you a good festive period, and we ask you to pass on our wishes to Lady Rice, who, unfortunately, could not complete her evidence giving.

I suspend the meeting to allow for a change of witnesses.

11:18

Meeting suspended.

11:24

On resuming—

The Convener: We will continue to gather evidence on the Scottish Government's draft budget for 2018-19. We are joined by Neil Amner, director and chair of the economic advisory group at Scottish Chambers of Commerce; Russell Gunson, director of the Institute for Public Policy Research Scotland; and Dave Moxham, deputy general secretary of the Scottish Trades Union Congress. I thank you all for the written contributions that you have provided.

It is probably fair to ask each of you to lay out at the beginning what you think your priorities are for the budget. What are its advantages and disadvantages? It would be helpful if you took a couple of minutes to give us an overview.

Neil Amner (Scottish Chambers of Commerce): Everybody quite likes getting something for free or extra cash in their pockets, especially in the run up to Christmas. Nobody likes to pay extra for something if they do not get anything back. That said, the business community's perspective is broad, as will be its take on the budget.

None of the numbers in the budget is particularly decisive in terms of people's spending patterns or investment programmes, but a number of points come out of it. One is the potential impact of the new tax structure on discretionary spend. There are a number of pressures on people's disposable income and we know that there is a mismatch between take-home pay and the cost of inflation and price rises in recent years. Other fiscal measures are impacting on that: auto-enrolment, council tax, and the apprenticeship levy and so on coming to business.

At the current percentage differentials, the budget is not particularly crucial. Either it is positive for those who are winning out of it, or negative for those who are paying a bit more tax. People's perceptions of that will vary according to their personal circumstances. A lot of people will say that they do not mind paying a little bit more if we get better public services and if there is better support for business.

If, having set that new tax structure, the percentage differentials increase across the bands, there could be an incremental effect on discretionary spend. Less money in people's pockets means that they are able to go out less frequently. At the top end, being a few hundred pounds worse off will not make a difference, but if it goes up to a couple of thousand pounds, we will see the impact on people's spending habits come through.

That links to economic resilience. The other day, there was an article in the press about people being concerned about being a couple of pay packets away from being worried about keeping a roof over their heads. If budgets are already tight in individuals' circumstances across the different income bands, people's natural inclination will be to put less money into their pension or savings, or whatever.

All that could lead to pay pressure and affordability issues across the public and private sectors. We appreciate that the cabinet secretary has to strike a fine balance and the committee and the Parliament will have to find a balance across all the competing pressures on the budget. Our biggest concern is about perception. If the budget proposals for a new tax structure create the impression that Scotland is a higher taxed jurisdiction than the rest of the United Kingdom, that could have an incremental effect on people who are deciding whether to relocate to work and stay in Scotland.

We know that there are pressures on recruitment and skills shortages. We also know that there are pressures on prospects for the economy, as the Scottish Fiscal Commission said when you heard from them earlier. At the perception level, if someone is deciding whether to accept a post, or retain or relocate their business in Scotland, the differential tax rates across the UK—the simple thought that Scotland is different and how it is different—could become a barrier. I am not saying that 1 per cent here or there is a barrier; it is the structure, particularly if it is amplified with higher percentages across the bands and with differences to the rest of the UK that might get worse over time. We are concerned about setting a precedent and where it might lead in three or four years' time.

There are also a few anomalies in the tax system that we would like to see addressed. We welcome the implementation of the Barclay review, but there are a couple of things to consider. For example, if you have a business on several floors in one building, and the floors are not connected, the business gets separate rates bills, which are higher than they would be if the business was in one property.

There are also some anomalies, for example, in LBTT compared to SDLT south of the border. There is group relief and no SDLT is paid if a property of one company in a group is moved to another in the group, whereas LBTT would be paid for that in Scotland. Those are indications—a bit like the income tax perception issue—of incremental elements that build up the cost of doing business in Scotland compared to the costs of doing it in the rest of the UK. At an individual, itemised level, those elements are not necessarily significant but, taken together, particularly with the perception that they create, they could be problematic. All of that leads to hidden costs and additional overheads for individuals and businesses that are already here and for those thinking of locating to or investing in Scotland. With that extra tax, the question is what the tax difference is. It is about checking that and making sure what it is, particularly for those on low incomes, because a number of benefits and tax calculations are driven by the UK basic rate. Checking that they are paying the right amount of tax could become an issue for individuals.

11:30

The Convener: I am sure that we will get some different perspectives from the panel. Who would like to go next?

Russell Gunson (Institute for Public Policy Research Scotland): Thanks for the invitation to give evidence today.

Overall, we think that, with some important caveats, there is a lot to welcome in the draft budget. To us, the income tax rises are necessary and therefore welcome. They will provide sufficient money, at least on the day-to-day spending side of things in terms of the departmental expenditure limits, to prevent real-terms cuts for most departments, which is welcome. Local authorities and the rural economy and connectivity face harder settlements, although there is a lot to welcome in the real-terms increases for the national health service, colleges, skills and universities.

The income tax cut element, though, is something that we think is not well targeted at the poorest households, which is an issue that we could get into during questioning. That element will benefit at least a number of low earners in high-income households—so, second earners, in essence. To us, the business tax allowances—or the cuts in revenue—are problematic at a time when the block grant is facing a real-terms cut that also applies to local authorities. Even a maximum increase in council tax will not be enough to claw that money back.

Where that leaves us is that although the budget is welcome for the coming year, beyond that there are still deep cuts to come that stem from UK Government decisions. Although the income tax rises are necessary and welcome, they will buy us only one year. Our analysis shows that there are around £250 million-worth of cuts to day-to-day spending in 2019-20 and, if we include NHS increases and police protection, the figure increases to around £350 million for non-protected departments. That is therefore a significant cash-terms, never mind real-terms, cut.

That leads us to our focus on what is beyond the next year. In the medium term, tax rises will not be sufficient to prevent cuts in Scotland, given the state of the UK-wide economy and the UK Government's spending decisions. Therefore, what we need to do, alongside the scrutiny on this coming year, is focus on how we can get Scotland's economy, the tax revenue per head and productivity rates increasing so that, in the medium term, tax revenue can increase through a stronger economy rather than only through tax increases. That is why a tax framework that lasts beyond this coming year, perhaps through multiyear spending settlements, would be welcome for us and for the wider economy.

Dave Moxham (Scottish Trades Union Congress): There are three priorities for us: investment in public services, which for us involves investment in public service workers' pay as well; the tax policy that we need to meet that; and the parts of business investment that we think are good and the parts of business investment that we think are unevidenced and need further work.

On the first of those priorities, the committee will not be surprised to hear that we believe that every public service worker in Scotland deserves at least an inflation-level pay rise. We use the retail price index for that because most people have housing costs to take into account, but that is part of a wider picture in terms of public service investment that we need.

We do not believe that the tax proposals are ambitious enough in either quantum or structure to meet that public service investment. This is perhaps counterintuitive, but we tend to concur with the IPPR that tinkering about with the tax bands at the lower level probably does not do what it says, or purports to say, on the tin. A simpler approach would have been to hold tax rates for everybody on medium wages and above and to build a more progressive and ambitious scheme to follow that.

On business investment, there is some really welcome stuff on capital investment, such as the capitalisation of the Scottish investment bank. There are a range of things that we think can help stimulate the economy and there is some welcome work to make up for what we think will otherwise be a shortfall in construction work over the next couple of years.

There is a real concern, which is reflected in the Scottish Fiscal Commission's report, that some of the business rates measures have never been proven to have any measurable effect on the economy. We continue to argue that the small business bonus scheme is wrongly constructed and that if you want to construct support for small business you need to be far more outcome focused in your approach.

The Convener: Thank you very much for that overview.

Neil Bibby: According to the Scottish Parliament information centre, there will be a £135 million real-terms cut in revenue funding to councils. Have councils been allocated sufficient money to maintain and protect services, and what will be the impact of such cuts on local services?

Russell Gunson: There is a £185 million real-terms cut before you bring in the ring-fenced specific grants; there is a £135 million real-terms cut once those are brought in. Clearly, a real-terms cut risks a real-terms diminution in quality of services, particularly given the cost side, which Dave Moxham mentioned. This is all looking at the spending side, if you like, but the cost side for local authorities is under big pressure. We will see what happens with the local authority pay settlement, but there is also pressure on services as a result of benefits cuts from the UK

Government and the tough time that many individuals and families out there are having. In general terms, the cut is a risk.

There are big spending commitments in the budget, such as the attainment gap money and the free childcare money. Everything apart from those things faces an even tougher time. In short, the budget is tough—it is one of the toughest. Having said that, it would be a lot tougher without the income tax changes that the Scottish Government has proposed.

Dave Moxham: We were concerned last year. Some remedial action was taken post the Government's first draft budget, which we went on to welcome, but we remain concerned. You will obviously expect me to talk a little bit about public service workers' pay. It is important to note that, as far as we can see, although the finance secretary argued that he wanted to see a pay rise across the public sector, he did not ask the Scottish Fiscal Commission to model public sector pay rises. We are stuck in that situation.

We think that the significant cut that we have just talked about will impact on the pay negotiations. We also think that it will impact on service delivery more generally. I want to link that to considering whether Scotland is a good place to do business; it is not just about the welfare of the people of our towns and cities or the workers. If you underfund planning departments and the core services that councils provide that allow businesses to operate, and you do not have investment, that is a real hit to both business and the livelihoods of the people we represent—I am quite certain that Scottish Chambers of Commerce will have plenty of complaints about the slow running of the planning service in various cities.

Neil Amner: Scottish Chambers of Commerce has long acknowledged that the economy is in essence an organic thing—I have certainly acknowledged that in other contexts—that has a number of components that need to work together in an efficient manner. Business relies on the public sector and on local authorities in particular for a great many of the support facilitation services that allow it to function. In the same way, it is important for the wider economy to have a healthy private sector in order to employ staff, pay wages and raise tax.

As I have said, I appreciate that there is a balance to be struck by the committee—and by the Parliament more generally—and we would be concerned about severe cuts to council services. Equally, individual members of the public as well as businesses will have concerns about how that would be funded, and a balance has to be struck in that respect. For example, significant council tax rises will compound existing pressures on households. I also note that the Barclay review took a considerable amount of time and effort and the views of a great many experts to come to its conclusions, and the non-domestic rates system has been shown not to be functioning either fairly or pragmatically. Again, there is a balance to be struck.

As for the other budget proposals, given the timescale between when they were announced and today, we would need more time to reflect more deeply on their potential impacts. The particular point about the effect on local authority budgets and spending is of concern to business, but we appreciate that a balance has to be struck.

Neil Bibby: According to SPICe, local government revenue funding has fallen by 8.5 per cent between 2010-11 and 2017-18, while Scottish Government revenue has fallen by 5.1 per cent. Given what you are saying, should local government get a fairer settlement? After all, COSLA has said that £545 million is needed "just to stand still". How much more money should local authorities get in the budget?

Dave Moxham: At the very least, the real-terms cut that you have just described should be reversed. However, as you have rightly pointed out, this is part of a sequence of cuts that are really just unsustainable.

On Russell Gunson's point that the income tax proposals will raise some more money, I have to say that a large part of that will disappear straight away as a result of cuts in business rates. As a result, we are not talking about that level of investment in public services—indeed, far from it. We have argued for more ambitious tax proposals, and we believe that the first port of call to receive that additional revenue should probably be local government.

Russell Gunson: Mr Bibby's point is that this budget comes on the back of a number of years of real-terms cuts to local authorities, which means that the low-hanging fruit with regard to efficiencies has most likely been taken. There might be other opportunities, but I think that a real-terms freeze and real-terms protection could be an aim in the budget process.

Dave Moxham is absolutely right. Council tax can go up by 3 per cent to mitigate some of the cuts to local authorities, but business rates revenue will drop by £100 million a year. Part of the remit of the Barclay review was to be cost neutral and it set out business tax-and-revenue-raising proposals that have not yet been implemented. We will see whether anything can happen in that respect in time for this year.

However, even if we can fix the situation for this year, the deep spending cuts will begin again next year unless we look at what we can do in the medium and long term. Some of that might mean further tax rises or, if it changes its plans, further spending by the UK Government; most of all, though, we will need a stronger economy. We can look at these things on a spreadsheet, but every penny that goes out the door needs to be tested against the country's twin priorities of inclusive growth and narrowing inequalities. Wherever we end up, that will apply as much to local authorities as to other parts of the budget.

Neil Amner: I broadly agree with the balance that Russell Gunson has referred to. We accept that there is pressure on local authorities, but there are a number of areas where we need to be very careful about the law of unintended consequences. If we were to protect council budgets in the way that Dave Moxham and Neil Bibby have referred to, how would we pay for that?

11:45

One option could be to raise council tax; another option could be to roll back on some of the concessions to rates. However, we have heard about the fragile state of the economy from the Fiscal Commission and we know about that from other evidence, such as business surveys. For example, we know that the retail sector has had significant difficulties, as has the hospitality sector, which actually led to the Barclay review.

I do not have an answer for you, but I urge caution in how you proceed. It would be a perverse outcome if we compounded problems in the wider economy by not implementing the Barclay review concessions, which were proposed on the basis of real difficulties being encountered by business. If the rates system is not reformed in the way that has been proposed, there could be significant impacts on individual businesses and on the wider economy on the back of that.

Neil Bibby: Russell Gunson said that a 3 per cent increase in council tax would not be enough to avoid all the cuts, so, as things stand, it is fair to say that council tax payers could be facing a 3 per cent increase in council tax as well as more service cuts. The Fraser of Allander institute has said that, for low-income taxpayers in the lowest tax band, the income tax reduction will work out at about £20 a year. Have you looked at whether they would be better or worse off after that tax reduction if their council tax goes up by 3 per cent?

Russell Gunson: If councils choose to use the power to increase council tax by 3 per cent, that will roughly keep it static in real terms, as inflation is running at around 3 per cent, so it depends. There has been talk about baselines and who is better and worse off as a result of the income tax policy, and the situation is similar for council tax.

On the specific point, if all councils across Scotland used the power to raise council tax by 3 per cent, it is estimated that that would bring in around £75 million to £77 million a year, which would bring the cut down to around £60 million in real terms. That would be less significant than the cuts that local authorities have faced in recent years, and it would be a lot deeper without the tax changes that the Scottish Government proposes, but it is still a real-terms cut on very pressured services.

Willie Coffey: I have a supplementary on support for local government. Do you acknowledge and accept that there is clearly additional support for local government in the budget? The SPICe figures show that the baseline settlement for local government is £10.38 billion, but when we add in all the extra support for local government, for things such as discretionary housing payments, the Scottish welfare fund, the attainment challenge fund and schools for the future, that takes us up to about £11.3 billion. Do you acknowledge that that additional support for local services is there?

Russell Gunson: We have looked at resource spending, or day-to-day spending budgets, so we have not included capital, financial transactions and lending. As I say, if we include all the things that you mentioned to do with the attainment gap and so on, that brings the cut down to around £135 million in real terms. If councils use their council tax power to mitigate that further, that would bring the figure down to around £60 million. That is a lot less than we have seen, but it is still a real-terms cut.

Willie Coffey: On top of that, we have the support for health and social care integration that is going in to support local services, plus reforms to the council tax system. Those are substantial additions. There is also £90 million of extra capital going into local government, plus the discretion for councils to implement the 3 per cent rise in council tax. There are levers and discretion that councils can apply, as well as that additional support. Do you acknowledge that that is there?

Dave Moxham: With respect, I recognise what you say, but I think that you are mixing and matching different things. You are mixing and matching capital spending and things that the Scottish Government has announced as priorities, such as the living wage in care and health and social care integration, and then allocating those budgets to local authorities as if it was always their responsibility to deliver on them. When the responsibility shifts jurisdiction, local authorities are still left with the set of services that they previously had to deliver and that they now have less money to deliver. Some of those are statutory obligations and some are expected obligations.

Local authorities have less money now than they did last year to deliver those obligations, and that has been the case sequentially over many years. We cannot get away from that fact, even though we welcome some of the programmes that you talk about with respect to local services.

Willie Coffey: Local councils are delivering those local services.

Dave Moxham: To repeat, they have less resource to deliver those same services that they delivered before the announcements were made. That is the base level. It is important to make the point that the trade union movement and, I hope, the Parliament generally value local authority autonomy. Therefore we tend to prioritise clearly the spending areas where local government has discretion to act, and to act in a way that is responsive to its own local citizens.

Russell Gunson: The Scottish Parliament's budget as a whole could be taken as including financial transactions, capital, lending powers and so on, and that would tell you one story. At the Scottish Parliament level, we focused rather on day-to-day resource spending. We also did that at local authority level.

You are right to suggest that capital investment is going to local authorities, particularly for childcare, which is very positive. Additional money is going to tackle the attainment gap, which is also the right priority. Although we can focus on the negative, there are thus also positives.

Overall, there will be a real-terms cut in day-to-day spending even if councils use their council tax powers, albeit a lesser cut than councils have faced in recent years.

Willie Coffey: On the health and social care money of £355 million, are you saying that councils do not have a role in delivering that?

Dave Moxham: I am not saying that they do not have a role. To repeat my point, services that local authorities would previously have been expected to deliver under their statutory and other obligations are receiving less money than they previously did. Many of the additional programmes are welcome. The health and social care provision is still working through, and we are looking to make sure that the ring fencing of the living wage for carers is going to be delivered and maintained. That does not change the reality that councils previously had more money to deliver their core responsibilities than they do now in real terms.

Neil Amner: I do not want to comment directly on the question but, in considering the impact on individual households and, for that matter, individual businesses, I encourage Parliament to look at household net income. Households regard their income as coming out of a single till. Whether money comes out as income tax, national insurance, council tax, VAT or whatever, people look at how much they have left to spend. That has an impact on the wider economy. Whether money is taken through income tax, or the council takes it through council tax, it is the bottom line that people are concerned about.

The Convener: Emma Harper wanted to concentrate on the impact of the budget on women in particular.

Emma Harper: I have a similar question to one that I asked of the last panel. I am interested in the impact of the budget, as it seems to be more favourable towards women. More carers and nurses are women, and many are in a salary band that means that they will benefit and will have tax relief. If we look at who the nurses, carers, those who provide child care, and those who provide the care at home for disabled people are, we see that it seems to be that women will benefit.

Russell Gunson said that income tax being cut is not going to benefit the poorest people. What would be your suggestion for fixing that?

Russell Gunson: You are right to highlight the gender aspects. I am conscious that we are an all-male panel talking about gender: I will watch my step a little bit.

More women are low earners and therefore may benefit more as individuals from the tax cut element of the changes. However, there is an opportunity cost. The tax cut costs a certain amount per year. What could be done to help women by using that money in a different way? The carers allowance top-up is an interesting way of using funding from the Scottish Government to help carers, predominantly women and other groups. We could look to that and use that same logic in a different way, as topping up benefits may be a much better way to use that money to help the poorest households and to help women.

The Convener: Does anyone else want to comment on that?

Dave Moxham: I was just being polite and waiting. We have not done the work on that yet, but I think that, from our perspective, some of the ticket items that you outline would probably have some beneficial effect for those in employment. As Russell Gunson said, women tend to predominate in lower-income jobs.

To return to public sector pay, the first thing to say is that the budget does not propose a real-terms public sector pay rise for anybody. It provides a real-terms public sector pay cut for everybody; it is just a question of what proportion that is. We would be particularly concerned if the local government settlement constrained the ability of local authorities to offer a decent pay rise, because we know that women in particular are carers and make up a large part of the lower-salaried staff in local government. Our other concern would be that any cuts in services more generally tend to impact on women worse. Again, we would make the case that a larger tax quantum and a more ambitious redistributive programme would allow redistribution of services not just to those in employment but to the 40 per cent of people who are not in employment, as mentioned by Russell Gunson's paper, and that that would have a more fundamentally rebalancing effect than what is currently proposed.

Emma Harper: Have you done an analysis on how the Scottish Government's draft budget compares with Westminster's budget when it comes to benefiting women and disabled people who are in work?

Russell Gunson: We have not done that analysis. However, it is clear that income tax cuts are proposed down south, because the rates are staying the same and the higher-rate threshold is going up with inflation in cash terms. Equally, there are steeper spending cuts and, as Dave Moxham says, services—particularly for the poorest—are more likely to help women than men. Lastly, of course, the benefit cuts that we are seeing at UK level are likely to affect women disproportionately. We have not done the analysis, but you can see which way it is likely to point.

Neil Amner: Likewise, we do not have the analysis, but we have some figures from the Institute of Chartered Accountants of Scotland that show that people earning below £24,000, taking into account both the draft Scottish budget and the draft UK budget, will have £90 a year more in their pockets. That is a modest amount, but it is still on the positive side for people in those pay bands. The question is how, with the structure that is being proposed in the draft budget of starter, basic and intermediate bands, other benefits are triggered. Currently, the basic rate is the trigger point for a number of benefits, positively or negatively. Does that stay the same? How do you work that through north of the border when benefits remain part of the UK system? Equally, there are questions about the calculation for those who are paying pensions, and obviously auto-enrolment is now there for everybody. For the third sector, the impact of the new bandings on gift aid is something that we have not really figured out yet. As you put a new structure in place, questions arise about how the consequences flow through.

Emma Harper: Thank you.

The Convener: I think that Patrick Harvie also has a question relating to that, and one about pay as well.

Patrick Harvie: I wanted to follow up briefly on the tax points that have been raised, before coming back to pay. It is fair to say that there has been a lukewarm, or less than lukewarm, response from a couple of witnesses to the reduction in income tax through the introduction of the starter rate. I suggest that there are a couple of reasons why we should not be too bothered about that. It is partly because, on targeting, there is no income tax change that we can make in Scotland that would benefit the very lowest income households, because they do not pay income tax at all, and what is proposed is probably better targeted than what was previously expected—the idea of introducing an extra zero band, in effect increasing the personal allowance, which would be far less well targeted than this, because the bulk of that tax cut would go to higher-income individuals and households.

Secondly, on quantum, the effect is £2 million or £3 million a year. It is really very modest and we should be much more focused on what is happening at the top three rates, which have a much greater ability to affect the scale of the Scottish budget.

12:00

Russell Gunson: We have not done the analysis on the quantum. Are you quoting the Scottish Fiscal Commission?

Patrick Harvie: I am referring to table A.6 in the Fiscal Commission's report.

Russell Gunson: It is categorised by the top rate of tax that someone pays, so I am not sure that that is the quantum for the overall cost of cutting tax. Perhaps you got that from the previous witnesses. I can come back to the committee with more detail on that, because it is hard to put it verbally.

Regardless of that, if there are opportunity costs and better ways of targeting even a few million pounds, we should look to them, particularly when, as we have just discussed, budgets are tight. However, you are correct to say that an even worse, less well-targeted proposal would be a zero rate or a personal allowance increase.

Dave Moxham: I would be surprised if the figure was not just for people who are earning that sum of money rather than the overall ripple effect in the system. A 1p tax cut for all income above £19,000 modelled right through the income scale is bound to be a lot more than a couple of million pounds. It must be about the impact on those people in particular rather than the overall quantum.

Patrick Harvie: Of course, if people just enter the intermediate rate, their saving lower down in the wage scale would be counterbalanced by the 21p rate.

Neil Amner: We are back to the point that I made earlier. We can give with the left hand and take away with the right if we give an income tax cut but then bump up council tax. For the people who pay council tax, it is counterbalanced. That is a fair point.

We must bear the structure in mind. We have heard a lot in recent years about the simplification of various systems, including tax simplification. The new structure flies in the face of that. That is why, in my introductory remarks, I mentioned issues to do with hidden costs and perception. We are trying to achieve a fair and inclusive settlement. We need to be careful about not overcomplicating things by introducing multiple bands.

On targeting, the figures that I have from ICAS show that there are 2.1 million people in Scotland who earn less than £44,000 and 350,000 people who earn more than £44,000, so that is a far smaller pool of people. It has been shown previously that, if we target the top end of tax systems, we create more of an incentive for people to take steps to avoid paying the higher-rate tax. There is a balance to be struck.

Patrick Harvie: We have discussed the degree of uncertainty that surrounds those potential behavioural effects.

The Convener: Neil, if we want to have a standard situation throughout the UK as you suggest, what would be the point of changing any policies? That would leave us with the fundamental question of what the point of the Scottish Parliament is.

Neil Amner: I will give an example of the point that we are trying to make. We know that we have a shortage of a number of key skills. Let us think about somebody who works in digital. A cybersecurity job comes up in Glasgow and in Newcastle, Leeds or somewhere similar. It is a relatively well-paid job. Let us say that that person earns—pick a number—£60,000 or £100,000.

The current draft budget makes a relatively modest difference to that individual. At £60,000, they will be £750 worse off in Scotland and, at £90,000, they would be £1,000 worse off under the current 1 per cent increase. However, they might think, “Hang on a minute, a new structure has been introduced. It is 1 per cent this year, but what is to say that it will not be 5 per cent in two or three years’ time?” Therefore, if they accept the job in Glasgow, they will stick out for another £10,000 to ensure that they are not out of pocket, but the employer will say, “No, chum. That is our budget. You are not getting it.” The net result of that is that that individual will not be recruited. We will simply reinforce our skills shortage, unless we can grow our own in the meantime, which we are patently not doing in the short term, at least.

The Convener: Such people might have young kids who will go to university with no tuition fees. Do they not consider that?

Neil Amner: What I am saying is that there is a perception issue. Let us say that a business is looking to relocate to or expand in Scotland. There is a perception that Scotland is different—our legal system is already different, and we know that our property transaction tax costs are significantly more than those just across the border. No one is going to rush to buy a house in Carlisle on the back of the draft budget or the draft tax structure but, over the piece, we are creating a perception that it is more difficult and more expensive to do business in Scotland.

The Convener: Where did you get the evidence for that?

Neil Amner: As I said earlier on, the system is untested—

The Convener: No. Where is the evidence for that perception?

Neil Amner: We already know that staff of European origin are leaving or are not coming to Scotland, not necessarily because of Brexit but because of the effect of the exchange rate. In the past, people would come here to work and get a bounce out of their salary because of the exchange rate with the euro, but the position has now reversed. People are no longer coming to Scotland on that basis. However much those of us who are not directly affected think, “You’ll be fine. It’s okay—don’t worry about it,” those who are affected by Brexit are, to varying degrees, concerned about their and their family’s future.

Scottish Chambers of Commerce puts a lot of effort into trying to sell Scotland as a positive place in which to do business. We sell Scotland in the round as a lifestyle place. There are the benefits of our university education, our easy access to the countryside, our international connections and our cultural offering. However, we also need to be careful that people get a balanced view.

The Convener: Okay. I had better let others reflect on that and get some life into this debate.

Dave Moxham: We seem to be focusing on Europe. I would argue that there are other, greater risks in respect of European people coming to Scotland. Most of those people come from countries that have a higher general level of taxation, which has been linked over a period of time to a more socialised model in which business, university education and a range of other things that make up a society are better interlinked. All the evidence shows that people consider a range of matters before they decide whether to move somewhere. It has been argued that that will not happen at the margin that we are talking about, and I would argue that a considerably greater margin would still not be the major reason that people would use. People look at the quality of education, the quality of life and the social infrastructure. This is extreme Laffer curve economics, and that is not where we need to be just now.

The Convener: We had better not get into that. We have been there already.

Russell Gunson: In our view, it is unlikely that the level of tax rise that we are talking about, particularly as the personal allowance has been going up and as we have seen income tax changes over the previous eight or nine years, will lead to the behavioural change that we have seen as a risk from increasing taxes for higher earners. My only caveat is around what happens if we come back to the issue every single year and uncertainty about what our tax arrangements are likely to be in three or five years' time begins to creep in. We should keep an eye on the situation. In longer-term decision making on tax, certainty is probably a good thing, even if that certainty is about increasing taxes.

Neil Amner: Just be clear, I am not saying that the current draft proposal is enough to put anybody off doing anything. At best, very marginal numbers are affected. However, I entirely agree with Russell Gunson's point. If the genie is out of the bottle and a new structure is being set out, how that structure evolves over time may create an effect.

To answer Dave Moxham's point, the rest of the UK is our biggest trading partner and our biggest source of talent. Therefore, we are not talking about only people who come from abroad; we are also talking about people who are considering coming from south of the border.

The Convener: Okay. I put the questions off track a bit, because I was getting a bit frustrated. As I did that, we will need to move on a bit quicker—forgive me. Patrick Harvie wants to ask about pay.

Patrick Harvie: There was a lot in there that I would like to respond to, but we are short of time. We have not talked about pay, and I am keen that we do that.

Dave Moxham has criticised the pay policy that was published alongside the budget and says that the pay settlement is below inflation for all public sector workers. Notwithstanding that there is a separate debate to be had about whether the rest of the public sector, including local government, needs to be funded to provide for a similar settlement, the Scottish Government has clearly gone further than the UK Government in trying to move away from the pay freeze and provide something more.

What would happen if we tried to achieve everything that is suggested in the STUC's paper, with increases in line with current inflation and projected future inflation—if CPI were used we might get to 3.2 or 3.4 per cent, and it is suggested that we use RPI, which is higher—and with an attempt to ensure that everyone in the public sector gets the same settlement, rather than having different offers above and below a certain salary level? Any of those policies would be another big step for the Scottish Government to make. Can you place an order of priorities on them? Are you more concerned that we take account of future inflation or use RPI? Are you less concerned about the equalities issue and ensuring that lower earners get a decent pay increase? Where do the priorities lie?

Dave Moxham: I will try to respond without stepping on the toes of my various affiliated unions, who all have bargaining units with specific employers. There is a range of interests, which need to be respected, because the unions are autonomous.

On your last point, what I can say is that public sector unions have habitually made pay claims that include weighting for lower-paid workers. I will not comment specifically on whether the Government's 2 and 3 per cent approach is exactly how we would want that to be done—obviously, even if it were the right approach, we would want uplifts of 3 and 4 per cent. There is clearly evidence that an element of weighting for low-paid people is important to public service unions.

You said that the Scottish Government has made an additional commitment. We have yet to see what that additional commitment is, in quantum terms. We argue that account has not been taken of that for local government. Local government down south has made an offer of 2 per cent to local government unions in consecutive years. That offer—2 per cent and 2 per cent—is not substantially different from the 2 and 3 per cent that Mr Mackay is offering, except that he does not appear to be funding that for local government, which is a large cohort, as you know.

The biggest cohort of all is health workers, of course, for whom the 2 and 3 per cent settlement is not on offer from Derek Mackay, although it seems that he will fund such a settlement if the pay review body at the UK level comes up short. We are not sure that the pay review body at the UK level will necessarily come up short, and of course Mr Mackay will get the consequentials when a settlement is offered, so were a similar deal to the one that he announced in his budget to be agreed at the UK level, that large cohort of workers would get no additional funding either. We have now taken out, if you like, the two largest cohorts of public service workers.

Mr Mackay's directly supported staff and those who work in non-departmental public bodies are covered by the pay policy, but a number of NDPBs have not received the additional funding that would be commensurate with matching the pay policy.

Sorry. That was a rather long way of saying that we have not yet been able to quantify what the difference is between Mr Mackay's commitment and what is happening at the UK level. Therefore, as the budget develops we will argue that Mr Mackay needs to make an additional commitment, such that all public service workers receive RPI plus, with any element of weighting dealt with in that context.

Patrick Harvie: You cannot yet quantify what that would involve.

Dave Moxham: We know that RPI inflation is predicted to run at 3.6 per cent—someone will correct me if I am wrong—and we know that the pay claims from all the cohorts of workers who have currently made a claim exceed that. There are other pay claims still to come in; we have not had the local government negotiation yet, and next year's teachers' negotiation is outstanding. What we do know is that RPI inflation is at 3.6 per cent and that, so far, every public service union has put in a claim above that.

Patrick Harvie: Would anybody else like to comment?

12:15

Russell Gunson: Following the new powers in the Scotland Act 2016, public sector pay now brings an income side and not just a spend side, as can be seen in the Scottish Fiscal Commission's projections for the economy. There are Scottish Fiscal Commission projections for public sector pay, which begins to drive tax revenue per head, which comes back into the budget. This is not a zero-sum game, in the sense that increasing public sector pay may well increase tax revenue, which may well come back into the budget, to some extent, to offset that cost. We have done a bit of work on that in the past. Having said that, I think that it would increase cost pressures, and the money, as I am sure we would agree, would need to be found from somewhere—either in additional tax or in cuts elsewhere.

Neil Amner: We have a very similar view. Additional pay for public sector workers means that they have more in their pockets and more to spend, which, as well as all the social justice aspects that come with that, is better for the wider economy. Our concern would be with how that would be funded and with the comparisons on the cost side for business as regards pressures on private sector pay that might follow through. The sort of rises that you are talking about are more about keeping pace with the cost of living rather than anything else. All I will say is that it is a question of how it is funded.

Adam Tomkins: In this conversation, we have lost sight a little of the context in which it needs to take place, which is one of historically subdued growth—"subdued" being the very polite term. Earlier today, we heard a lot of evidence from the Scottish Fiscal Commission that one of the principal drivers of such subdued growth is very poor productivity. The conversation about pay needs to be tied into that essential context in which the budget must be understood. Will increasing pay in the public sector, without any improvement in outputs, not simply contribute to even more quickly declining productivity, which will make things even worse?

Dave Moxham: Most people now recognise that we have clear and developing skills shortages in the public sector. Reducing the quality of work—which happens if we reduce pay, and particularly if we cannot fill vacancies—is intensely unproductive. Losing the public service framework that is provided for business through city infrastructure and support services is very bad for business, too.

There is no particular problem with productivity in the public sector. What we do have is a problem with productivity more generally, based on a collation of poor and insecure jobs in the wrong sectors of the economy. There is a limited amount of things that the Scottish Government can do about that in relation to the private sector, but—broadly speaking, and with the exception of what we think is badly targeted business rate activity—we have applauded what it has done. However, at the end of the day, the Scottish Government is partly stuck in a position that is not of its own making, because the problem is with UK Government policy. Year on year, its policy has not helped productivity; it has fetishised getting very low levels of unemployment, but it has not really concerned itself about the quality of employment. By common consent, that is the biggest problem with productivity growth across the UK.

Russell Gunson: The productivity problem does not exist just in the public sector. More importantly, it is in the private sector that we need to crack it. There is a big, long tail of companies across the UK that sit in retail, hospitality and care and that have much lower productivity than their equivalents outside the UK. That is where a great amount of that productivity gap rests. I agree that the economic context in which the budget takes place is bleak: it is bleak across the UK and a little bleaker in Scotland. However, the way out of that is productivity growth, as the Scottish Fiscal Commission suggests.

Although the Scottish Government's powers are limited in that respect and there is a lot more that the UK Government could be doing, within the context of the Scottish Government's powers, the places to look would be around the national investment bank—the capitalisation of which is very welcome and interesting—and, more generally, capital investment in infrastructure, which is also positive. In relation to resource spending, looking at the £2.5 billion that goes on skills, colleges and universities and testing it more tightly against productivity improvements, inclusive growth and inequalities would be a useful and interesting exercise, which could be done by the new enterprise and skills strategic board.

Productivity has to be the priority, particularly in the private sector, in the areas that I mentioned. Although many of the powers rest with the UK, there are some good things to welcome in the Scottish context and we can push things a bit further in parts of the spending departments.

Neil Amner: Mr Tomkins is right to raise the challenging, fragile state of the economy and its prospects. We, too, look forward the outcome of the new enterprise and skills strategic board and its budget. We also welcome the proposed spend on broadband, the national investment bank, the national manufacturing institute and the money that is being allocated for research and development.

Productivity is a challenge across both the public and the private sectors. Russell Gunson touched on retailers earlier and the concern is that there are significant difficulties with revenue, cash flow and profitability and therefore business sustainability. In other contexts we talk a lot about the challenges and demise of the high street. We need to be very careful about where we place our bets on that one.

On the concerns about the inclusive and organic nature of the economy that I mentioned earlier, the question is how public sector staff budgets will be funded, where in the private sector the burden falls and therefore whether it is affordable.

The Convener: Adam Tomkins has a question about skills and training, but James Kelly has a supplementary question on Patrick Harvie's point.

James Kelly: I have a direct question for Dave Moxham. You have criticised the level of settlement for local councils and expressed concern that there is inadequate funding in the budget to cover the pay settlement announced by the cabinet secretary, but you also say that you would like to see a pay settlement at a higher level. As the budget progresses through the Parliament, what scale of financial changes will be required in order to address your concerns?

Dave Moxham: I have not exactly quantified that, but I will throw out a figure anyway—why not? The STUC was clear that the Scottish Government's tax changes should be in the region of twice or three times as ambitious as the most ambitious quantum that it proposed in its tax paper. I would suggest that significantly more than £500 million should be found; a large proportion of that needs to be invested in local government to cover an inflation level pay claim, although some would also be available for investment in other public services.

Adam Tomkins: I am sorry if I am jumping around from topic to topic. I want to go back to the point that you raised in response to my question on growth of productivity. Surely one of the key infrastructure investments that we need to make is in skills and training. We have heard a lot from a variety of our witnesses, including Neil Amner, that there is pressure on recruitment and skills. What is your reflection on the fact that the Government's budget proposes keeping the skills and training budget flatlined at £232 million? That is just the same as it was last year, with no additional investment, notwithstanding the pressures that we hear that there will be post-Brexit or with regard to productivity. Is that the right judgment? If not, what other budget line should be cut in order to increase the spending on skills and training?

Russell Gunson: We have done a great deal of work on the skills system over the past year or so, in particular on how it links to improving our economy, and productivity is part of that.

You are right to say that, in real terms, the budget is not going up; across colleges, schools and universities, it is, but the pressures that we have heard about in relation to public sector pay and so on exist just as much in those sectors as elsewhere. There are also potential spending commitments because of policy commitments—for example, from the independent student support review group that I sat on, which was chaired by Jayne-Anne Gadhia.

Should the budget be higher? We can see that of course it should, if we look at the challenges that we are facing, such as UK-wide Brexit and the potential immigration changes that will follow—in fact, never mind the changes that follow; we are already seeing an impact on immigration levels as things stand.

This should not be only a public sector problem—that may be music to your ears. Public investment in skills is very important, but business investment in skills is equally important, if not more so. In recent years, in Scotland and across the UK—due no doubt to a deteriorating economy and deteriorating levels of confidence—there has been a reduction in business investment in skills. In addition, the pattern of that investment is not what we want to see if we want to achieve inclusive growth, including growth in low-productivity areas. You are much more likely to receive an investment from your employer if you are high skilled than if you are low skilled. There are things that we need to look at in the pattern of employer investment in skills that will help.

Lastly, it is not just about increasing skill levels. Scotland has the highest level of qualifications in the whole of the UK in terms of higher national certificate qualifications or above, but the utilisation of those skills is really important too. Again, that cannot be done from here in Holyrood or from St Andrew’s house; it has to be done in partnership with employers. It is as much about how we get employers to better utilise the skills that we already have as it is about improving skills.

Dave Moxham: I associate myself with everything that Russell Gunson said there, so I will not repeat it. Adam Tomkins asked where the money should come from. We need to tie support for business more directly and organically to action taken on skills and provision of quality employment. That is why, for instance—sorry to repeat myself—we think that if money is going to be provided to small businesses, it should be provided on the basis of what they will create and how they will boost the economy rather than just as a flat-rate rebate. Some of it is used in a useful way; some of it is funding second cars for people.

Let us look at big lumps of money such as that £200 million; let us look at the fact that that more or less equals the budget that Adam Tomkins just spoke about and see how such budgets can work together so that we get additional investment in the strategic areas of skills development and research and development, which will help our economy to prosper in the future.

Neil Amner: In broad terms, we are all in agreement. The chambers of commerce network has said consistently for several years now that it has concerns about skills issues and recruitment and retention. The network is heavily involved in the developing the young workforce programme and business-to-business mentoring. We have 1,000 mentoring opportunities up and running already.

One specific thing that I would flag is the fate of the apprenticeship levy across the UK. If you are down south, you pay the apprenticeship levy and then you can claim that back through your training spend. Up here, it goes to the college sector. As a policy decision, it is not necessarily bad in itself, but it creates some perverse incentives—for example, larger companies are sending people down south for training programmes, which seems a bit nuts. Let us keep the skills in Scotland and grow the economy in Scotland—but more power to our elbow on that one.

The Convener: Ash Denham has a supplementary on skills. Is it related to the labour market or the national investment bank?

Ash Denham: It is related to the national investment bank. I want to pick up on a couple of points from the IPPR paper. You noted that capitalisation of the national investment bank was “welcome and interesting”. You also said that that was 5 per cent of the capital budget over two years, which is quite a high level, and that in the future, the bank would be provided with financial transactions. It strikes me that that might be quite a good use of financial transactions money, compared perhaps with what the UK Government is using it for with the housing market down south. You said that it could boost levels of investment and productivity. Will you expand on that a little?

12:30

Russell Gunson: We have called for the establishment of a national investment bank across the UK for a long time. Such banks exist and do a good job in lots of other countries. It is welcome that the Scottish Government has set up a Scottish national investment bank, and the capitalisation over two years—starting not this year but next year—is welcome. The reason for that is slightly related to what we were just saying about business investment and skills. The more that we can use public funding to gear in funding from outwith the public sector, the better. Partnership between public funding and business or employer funding is always going to maximise the impact that you can get from that funding. In Scotland, just as in the UK, there is a real gap in terms of business investment, whether that is in research and development, infrastructure or more generally around skills.

This is a really interesting innovation, in the sense that it could begin to change employer behaviour and gear in employer investment. As long as it is focused on the long-term—which too little of the investment at the UK level is—we will begin to see some long-term benefits around productivity growth and so on.

I absolutely agree with the point about financial transactions. At the UK level, they are being used predominantly in relation to housing, including the help-to-buy policy. We have done some of that in Scotland, but that funding could have a much greater impact if it were used to invest in some of the things that we talked about that would boost productivity. Investing in help to buy is not likely to have a large impact on productivity; investing in some of the long-term patient capital is much more likely to do that.

The Convener: I am conscious of the fact that business in the chamber starts at quarter past one today—there is an extra members' business debate—and we have to consider a report in private after this evidence session, so I am afraid that we will have to speed up a bit. That said, Murdo Fraser has a question.

Murdo Fraser: I do not know what you are implying, convener.

The Convener: I am implying that I know that your question will be short.

Murdo Fraser: It will be. I have a question for Russell Gunson on the IPPR report. It says:

> "Improving the performance of Scotland's economy, and more particularly, tax revenue per head in Scotland relative to the rest of the UK, will be crucial to ending public spending cuts in Scotland in future years."

I do not know whether you caught the evidence that we got from the Fiscal Commission earlier, but you have probably seen its written report. Clearly, its projections indicate much slower economic growth in Scotland over the next four years. What, in your view, does that mean for the trajectory of tax rates in Scotland between now and 2021?

Russell Gunson: It is important to get the scale of the tax changes that have been announced in perspective. They account for about 0.1 per cent of GDP, so they are not huge tax rises at this point, but they are welcome because, as we said, they are necessary.

Beyond that, we know the allocations to the Scottish Parliament for next year, we know the block grant adjustment and we have the tax revenue projections from the Fiscal Commission. With that information, we know that, as things stand, we are likely to see deep cuts starting again. We are talking about somewhere around £250 million in real terms across all spending on the resource side and £350 million on the non-protected side—that is somewhere around 3 per cent, which is significant. Further, the IFS project deeper cuts at the UK level, which will impact on our budget.

Something will have to give. Cuts will have to start again, there will have to be additional spending through a change in policy at the UK level or there will have to be further tax rises of some sort—whether they involve income tax or other taxes—in Scotland.

Looking beyond this year, that is the prognosis. The key to what is going to happen links to the question that Ash Denham asked a minute ago. Improving the economy and strengthening tax revenue per head would enable us to escape cuts in future years without having to increase tax—in essence, it would enable us to run to stand still.

Murdo Fraser: Do you have a figure for the level of tax increases that would be needed to fill the gap that you are talking about if the economy carries on in line with the projections of the Fiscal Commission?

Russell Gunson: The net effect of the tax changes for this year is around £164 million. As I say, cuts across the whole of the budget next year are around £250 million, which is therefore more than the revenue raised through the proposed tax changes this year.

The Convener: Just for the record, do you mean the following financial year?

Russell Gunson: I should say 2019-20. For 2019-20, £250 million is cut across all spending on the resource side and the tax changes proposed for 2018-19 will raise £164 million. More would therefore have to be done than what has been done this year.

Murdo Fraser: Thank you. To put that point to Neil Amner, given what you have already told us about your members' views on tax rates, I presume that you would be concerned about that if it were to follow through.

Neil Amner: Yes. On the earlier point about investment, we need to grow the economy so that we do not have that gap.

The Convener: Dave, do you want to add anything before we move on?

Dave Moxham: No. Russell Gunson summed it up well and I obviously disagree with Neil.

The Convener: Ivan McKee, do you want to come in?

Ivan McKee: No, I am fine.

The Convener: Alexander?

Alexander Burnett: Thank you, convener. I note my entry in the register of interests around businesses and being an employer.

It is disappointing to hear a lot of the blame for productivity being put on businesses in the face of the burden of costs being imposed on it. When it was before the committee, HMRC described how the additional rates being created cost them up to an extra £5 million in administration. Has any assessment been done of how much the additional rates will cost businesses for things like payroll and software and so on?

Neil Amner: I have not got the figures for that. The National Audit Office talked about trebling the cost of administering a tax system when it has multiple layers in. I guess it is something along those lines. An employer who has employees north and south of the border will effectively have to run double payroll systems. Even at the individual level, you are going to have to spend more time checking and re-checking. The tax system is going to spend time going back and fixing and redoing calculations for tax and, potentially, for benefits because of the confusion about where the lines are.

Dave Moxham: Cuts to staff at HMRC and future office closures are going to be to the detriment of business and the public Exchequer. Unfortunately that is not in the hands of the Scottish Government just now.

On the more general point, it is not our biggest concern but, given our general view that the advantages of a very small tax cut for people whose wages are at the lower end are moot, it becomes significant to us that the extra complications and costs might not be worth it, given that we are not particularly convinced of the benefits.

Russell Gunson: I do not blame businesses for productivity; it is quite the opposite. They are part of the solution, alongside Government.

Although additional bands might increase the burden, other countries that have much better productivity than us have similar numbers of tax bands. They can cope with higher productivity levels than those about which concerns have been expressed.

The Convener: I thank the panel for coming along and giving us evidence prior to Christmas, and I wish you a good festive break.

I now move the meeting into private session, as we want to crack on with our report.

12:38

Meeting continued in private until 12:45.

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