OFFICIAL REPORT
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Finance and Constitution Committee

Wednesday 10 January 2018

Session 5

The Scottish Parliament
Pàrlamaid na h-Alba

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FINANCE AND CONSTITUTION COMMITTEE

1st Meeting 2018, 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:

Robert Chote (Office for Budget Responsibility)
Simon Fuller (Scottish Government)
Aidan Grisewood (Scottish Government)
Derek Mackay (Cabinet Secretary for Finance and the Constitution)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Finance and Constitution Committee

Wednesday 10 January 2018

[The Convener opened the meeting at 09:30]

Draft Budget 2018-19

The Convener (Bruce Crawford): Welcome to the first meeting in 2018 of the Finance and Constitution Committee. I wish members and everyone else around the table a happy new year. We have received apologies from Alexander Burnett and from Graeme Roy, who is unable to come to give evidence today.

Under the first agenda item, we will take evidence on the Office of Budget Responsibility's "Economic and fiscal outlook" and "Devolved taxes forecast" reports, which were both published alongside the United Kingdom autumn statement in November. We are joined for this item by the OBR chairman, Robert Chote. I welcome him to the meeting and invite him to make a short opening statement.

Robert Chote (Office for Budget Responsibility): Thank you, convener, and good morning to everyone. It is a great pleasure to be here. I am conscious that I am your first appearance in the new year for the second year running, which suggests a degree of masochism on your part that is much to be commended.

Since I last appeared before you, we have published two forecasts, in March and November last year, and our next forecast will come with the UK spring statement on 13 March. That will be the first time that we will have a chance to take detailed account of the Scottish budget measures that you are considering at the moment. Therefore, any questions that I answer for you on those will necessarily be somewhat vague and provisional until we have fully crunched the measures for that forecast.

On the process, we have once again had very useful interactions with the Scottish Fiscal Commission and officials of the Scottish Government. Both organisations have been very generous with their time and expertise to provide input that has been useful for our forecasts, and I hope that we have been able to help them with their preparations and deliberations now that the fiscal framework has moved forward to the stage of the commission being fully responsible for forecasts.

We are independent institutions and we have a shared lack of anxiety about coming up with different answers to the same question, but we feel a shared responsibility to explain to you as best we can why they are different—if they are different—and to be as transparent about that as we can. The commission's December document was a model of how to do that.

On the substance, for the forecast that we published in November, the backdrop was one of economic growth that had been somewhat weaker over the first three quarters of 2017 than we had anticipated back in March. The Brexit squeeze on consumer spending came one quarter earlier than we had anticipated, although there was no substantive difference. More notable was a feature that has been consistent in our forecasts for years, which is weaker than expected performance in productivity and stronger than expected performance in employment, within a given outcome for economic growth.

The most substantive revisions that we made to our forecasts in November, relative to those in the preceding March, involved taking a step back to look at the record of productivity growth over the period since the financial crisis, which was much weaker than it had been in the period running up to the financial crisis or a little bit before—it is not clear whether that is actually the point at which the pattern breaks. We noted also that that phenomenon is by no means unique to the UK. In many industrial countries, we have seen that unexpected weakness in productivity relative to preceding patterns. The revisions to underlying productivity growth made by the United States Congressional Budget Office are very similar to those that we have made over the past five or six years in response to the same sets of issues. In addition to a weaker period of trend productivity growth we assumed some offsetting factors: we assumed that unemployment could be sustained at a lower level than was previously the case, taking different views on the average hours worked in the economy, participation rates and so on.

The net effect is that we have judged the growth potential of the economy over the next five years to be less than we thought back in March, by taking a view on productivity that is roughly in between the record of the past few years and the earlier, much stronger, period. Weaker potential gross domestic product growth means weaker actual GDP growth and weaker growth in all the major tax bases, so that has implications for the public finances.

In November, the recent news regarding the public finances had been somewhat better than expected. The Office for National Statistics had revised down the budget deficit for 2016-17, the previous year, and things were proceeding relatively well in 2017-18, so we started off with the public finances in slightly stronger shape than we had anticipated back in March. However, with a weaker outlook for the economy, that initial unexpected good news was used up and by the end of the forecast period there was higher Government borrowing than we had had in the March forecast.

The policy measures that the UK Government took in March added a bit to borrowing in the first couple of years. There was some extra spending and some tax reductions, but with much less effect, towards the end of the forecast period. A weaker outlook for the economy has been driven primarily by stepping back and looking at the historical performance of productivity, and by a weaker outlook in the medium term for the public finances.

If you look at that in the context of what the Scottish Fiscal Commission produced in December, you will see that it had a weaker outlook for Scottish GDP growth than we had for UK GDP growth. We have UK GDP growth averaging about 1.4 per cent a year over the next five years; the commission has Scottish GDP growth somewhere below 1 per cent. The major drivers of that difference are weaker assumptions about prospective population growth; that is the largest single factor. The commission has also take a marginally more pessimistic view about underlying productivity growth than we have done. Much less important in quantitative terms is a difference in the view on the amount of spare capacity that exists in the economy at the moment, and different assumptions about net inward migration.

In terms of the devolved taxes picture, for income tax the relevant comparison is between our November forecast and the Scottish Fiscal Commission's December forecast, excluding the impact of the announced changes to income tax rates, which we obviously did not include in the November forecast. That like-for-like comparison gives a similar picture, with differences of less than 2 per cent in each year of the forecast looking forward, and slightly greater differences in the interpretation of what has happened over the past couple of years.

Obviously, we have not yet had a detailed look at trying to cost the income tax measures. I note that the commission has basically taken the taxable income elasticities—the estimates of how taxable income responds to changes in the marginal income tax rate—and has come up with something that is consistent with what we have used in the UK context for changes of that sort, but assuming that there is greater responsiveness for higher incomes. The commission reasonably points to the greater possibility of cross-border issues between Scotland and the rest of the UK, and that is something that we will have to reach a judgment on.

One other thing that we will take into consideration is whether the fact that the UK taxable income elasticities are estimated on a measure of income that includes dividends, whereas the Scottish tax base does not include dividends, should lead us to different conclusions. Another thing that we will need to look at is forestalling. The commission has not made a specific adjustment for that, but we will need to decide whether we want to do so. Again, the fact that the tax base excludes dividends means that the channel through which most forestalling activity tends to take place is excluded. With both of those judgments, I do not think that if we take a different view it means that there is a dramatic difference of opinion or that the difference will be quantitatively terribly significant.

On land and buildings transaction tax, the differences between the forecasts are slightly larger, as you would expect for a much more volatile tax series, but our methodologies are now pretty close. We have moved in the direction of the approaches that the Fiscal Commission uses, and we both keep those under review.

On landfill tax, much smaller quantitative numbers are at stake, while the percentage differences in the forecast are slightly greater. That is probably because the SFC has had more recent information on the infrastructure for incineration than we have, and so we will look at that when we get to the March forecast as well.

I hope that that covers most of the territory relatively briefly. I am happy to take any questions.

Murdo Fraser (Mid Scotland and Fife) (Con): We could just go home. [*Laughter*.]

The Convener: It was a very helpful introduction, which has set out the ground for us.

Mr Chote, in your opening statement you picked up on the issue of spare capacity in the economy. That was one of the issues that the SFC raised with us in its report, which we discussed with it before Christmas. It suggested that, in Scotland, we were over capacity. In your own report, the largest change that you have made to your economic forecast is

"to revise down trend or potential productivity growth"

by an average of about 0.7 per cent a year. You also state:

"the economy is operating near potential and ... the output gap is small".

Will you explain in a bit more detail what you mean by that, and why you have decided to revise down the growth because of it? Those circumstances, and the information from the SFC—which is not the same but has the same trajectory as your own—seem to me to beg the question of where we are going to get growth from.

Robert Chote: Conceptually, the way in which we think about the path of actual GDP growth over the next five years involves taking a view of what will happen to potential GDP growth, which is all the potential output of the economy, or the level of output of goods and services that is sustainable in the sense that we would not expect it to put consistent upward or downward pressure on inflation. In the context of the UK, we assume that the Bank of England is pursuing an inflation target, so the implicit idea is that, once it has got inflation to a level with which it is happy, it will want to keep actual output in line with potential output so that inflation is not being shoved up or down from that level.

Therefore, an anchoring assumption for our forecast is that, unless we are starting from a position with a very big or small output gap, we will end up with actual output being equal to potential output. In that case, the actual amount of GDP growth that we will get over the next five years will reflect that growth in potential plus anything that we add or subtract given how far away we are from potential to begin with. As the convener has said, at the moment, our judgment is that the economy is fractionally below potential—by less than half a percentage point; and the SFC's view is that, in Scotland, it is about half a percentage point above potential. I would not argue that such differences are significant in the context of the uncertainty that lies around any estimate of that number to begin with—we cannot directly measure potential output in the economy by counting up the number of widgets that are produced; it is a concept of how many widgets could be produced, consistent with inflation being stable. At the margin, if we start above potential, as the commission suggests, actual GDP growth will be slightly weaker than potential GDP growth over the five years; and for us, it will be slightly stronger. However, much the more important determinant of how quickly the economy grows, and how quickly tax receipts go, is that growth in potential—not the starting point, because the difference is not that great.

Why have we revised down growth potential? Primarily, it is because of the judgment that we have made on potential GDP growth, which we have pulled down significantly between the March and November forecasts. I want to clear up one point: it is not a judgment in which we are saying that we have taken a fresh, detailed look at the potential implications of Brexit. We did make an adjustment to potential GDP growth in an earlier forecast for that reason, but we have not revisited it. It is more a question of looking at the puzzle of why productivity growth has been so much weaker over the past decade than it was over the three or four preceding decades—it has been roughly 0.2 or 0.3 per cent a year since the financial crisis, compared with 2 per cent a year, or a little above that, beforehand.

09:45

Going back a few years to the forecasts that we were producing in 2011, 2012 and 2013, we would have been pointing to a number of potential explanations that were linked closely to the financial crisis, such as the hoarding of labour, as firms assumed that things were going to get better just around the corner, or the problems in the financial system that were preventing capital from being reallocated away from inefficient firms towards efficient ones. However, as the period of weakness has gone on and as it has been mirrored in other countries as well, it is not as plausible to rest weight on those temporary explanations that say that the position will be difficult for a couple of years but then, fairly quickly, we will snap back to the historical average.

The judgment that we have had to make in taking a view on the medium-term outlook is, basically, what weight to place on the weak performance of the last 10 years versus the stronger performance of the preceding 30 to 40 years. There is not a huge amount of science in that—we have roughly split the difference between the two periods, because nobody has firm explanations for why the dramatic slowdown has happened.

The Fiscal Commission, as far as I can read from its numbers, similarly has looked for what is roughly halfway between recent performance and earlier performance. It might have shaded into a slightly more pessimistic side of that balance than we have, but I would not overstate the significance of that difference. For both of us, and for anybody who is doing a medium-term forecast—whether for Scotland, the UK or any other large industrial country—the puzzle of what weight to place on the remarkable difference that we have seen between the last 10 years and the previous 40 stands out as the single most important and unfathomable challenge facing economic forecasters.

The Convener: There we go then.

James Kelly (Glasgow) (Lab): Good morning. I will pick up on the issue of weak growth and the way that you have taken another look at the forecasts. One of the drivers of output is average hours. The view that you have taken previously since the financial crisis—and there is evidence to back this up—is that the average number of hours worked has increased. The implication seems to be that the wages that people are earning have not kept pace with inflation, so people have had to either take on other jobs or work extra hours to make up the shortfall.

You are now saying that you thought initially that that trend would eventually start to correct itself, but that is not happening. I am interested in your assumptions for the future about whether average hours of work will continue at that higher level. Is the implication that people will have to continue to work increased hours because their core wages, if you like, are not keeping pace with inflation? Is that trend going to continue?

Robert Chote: You have explained that very well indeed. A very long-standing trend is for average hours to decline over time—we are talking about decades to centuries of evidence for that. As you say, that ceased to be the case over the time of the financial crisis, and we have seen average hours going up.

Again, as with productivity, when we are confronted with an abrupt change to a relatively long-standing historical pattern of that sort, we have to decide whether it is just a temporary aberration and we will get back to the long-standing downward trend or a more substantive and permanent change has occurred. The view that we had taken in most forecasts prior to the last one was that the change was pretty temporary and we were going to see a return to the downward trend. That view is very much linked with the idea of our assuming, as I mentioned a moment ago, for what it is worth, that some of the explanations for weak productivity growth were temporary ones that might be related to the financial crisis and that we would, therefore, get back to something more normal relatively quickly.

The fact that that has not happened and that we have simultaneously made the judgment that productivity growth is going to be weaker looking forward and, therefore, earnings growth is also going to be weaker looking forward, seem logical alongside our judgment that it cannot be assumed that we will snap back to the long-run decline in hours as quickly as we had previously assumed.

In deciding what to do alternatively, we do not want to overstate the science involved, but we have essentially assumed that the position looks flat going forward. However, there is clearly significant uncertainty on both sides. One of the uncertainties, as I said, is just in knowing whether people are responding to the unexpected weakness of earnings growth and so are wanting to protect their incomes by, as was said, working longer hours, having a second job or something like that; or whether, in a world in which people get used to weaker earnings growth, they will just adjust their expectations of living standards and maybe want to go back to that downward trend. Therefore, there are considerable uncertainties in both directions. However, the broad judgment that we have made is that we do not see a snap back to the downward trend as quickly as we would otherwise have assumed and we assume, for the sake of argument and for the sake of the forecast, that the position will be flat from here on out.

In terms of potential GDP growth, there is therefore a slight offset to the productivity adjustment, because if people are working more hours than they otherwise would have done, there is more income and more economic activity going on. However, it is only a small, partial offset to the larger, more significant adjustment to potential productivity growth.

James Kelly: That is helpful. My next question is linked to that. Over the past year, there has been an increased political focus on trying to address the issues around public sector pay and giving fair increases to public sector workers. Obviously, we await the round of wage settlements that is coming up, but it is fair to say that there is a greater political impetus behind the issue. Have you taken that into account in the forecasts?

Robert Chote: At the whole-economy level, which is the way in which we tend to look at the pay side, the fact that we have weaker productivity growth implies weaker earnings growth in cash terms and weaker growth in real earnings than we would otherwise anticipate. We have not taken into account the announcements by the Scottish Government on public sector pay, and I am not sure that the Fiscal Commission has done that either, as the matter came up relatively late in the draft budget process. I think that the Fiscal Commission produces an earnings forecast and an income tax forecast on a more bottom-up basis than we do, looking at the public and private sectors and bringing those together, which reflects the greater importance of public sector pay in the Scottish context.

For the UK forecast, we had to address two issues, one of which is the fact that the Westminster Government is placing less constraint on public sector pay. Basically—this is simplifying the situation somewhat—it is no longer constraining public sector pay increases to 1 per cent a year, but it is not presenting an alternative policy on what those increases should be. Simultaneously, Government departments have been given some more money to spend over the next couple of years, and the judgments that we have to make combine those two issues. We assume that, if the Government no longer instructs public sector employers to keep pay increases to 1 per cent, the pay figure will be higher. We assume that, because that constraint has been lifted, public sector pay will return to the whole-economy average or to being in line with private sector pay more quickly than we would previously have expected.

How will public sector employers respond to that? They might respond to it partly by changing the balance between pay and non-pay in the allocation of their budgets. If they want to spend more on pay or are under pressure to do so, they might try to spend less on procurement and put some more money into pay on that basis. However, the other way of addressing the matter, even if they have managed to put some more money into the pot from that non-pay source, would be to have higher pay growth in the public sector but fewer jobs. If, in addition to that judgment, the Government provides more money for departments to spend, they will spend some of that money on pay and some of it on non-pay.

Our overall judgment is that we will see lower public sector employment than we would have seen otherwise because of the relaxation of the pressure on pay. Some of the pressure will be soaked up by a reallocation from non-pay to pay and some will be soaked up by the fact that the Government has provided more money for departmental spending over the next couple of years.

James Kelly: Okay. Thank you.

The Convener: Willie Coffey has some questions in the same area.

Willie Coffey (Kilmarnock and Irvine Valley) (SNP): Good morning, Robert. I was going to ask you what has been done to address the poor performance on productivity over the past 10 years compared with the previous 40 years, and you have offered some suggestions. What can Governments or industry do to provide a stimulus to change the situation? It is as though we have got into a frame of mind whereby, following the financial crisis, industry does not want to change and there will be no movement until something else happens. What could reasonably be done to provide a stimulus to turn the situation around in the way that we want?

Robert Chote: The fact that we are talking about a global phenomenon indicates how difficult that will be. It is not simply a case of pointing to a particular deficiency in national policy in one or two countries that can be addressed to bring them into line with other, better-performing countries. Since the crisis, the UK’s productivity performance has been weaker than that of most countries, but it is a global phenomenon.

Numerous reports have been produced on what we could do to boost productivity. They tend to say that we should spend more on things such as training, education, infrastructure and planning reform. The list of long-term structural reforms tends not to change. However, those things can always be revisited. Have we ever pursued any of them as much as some people would say is necessary? Turnaround implies a rapid response, but all such productivity-enhancing policies are by nature slow-burn ones. The great challenge is in knowing what effect they have had. If we see productivity growth improving or declining over the next five to 10 years, we will not necessarily know the extent to which that is a response to a particular set of policy developments. It might be that the underlying productivity puzzle has resolved itself in one way or another.

There are those people who say that we are too optimistic and that we should assume that the past decade is the new normal. The most extreme techno-pessimist view has been put forward by an economist in the United States called Bob Gordon. Simplifying the situation somewhat, his basic argument is, “We’ve had three industrial revolutions and that’s your lot.” In other words, we will not experience a similar pick-up again. However, I do not think that we have the evidence to be in that camp. We are assuming that productivity growth will begin to pick up. It is still reasonable to expect that for a couple of reasons, one of which is that the labour market is tightening. That comes back to the point that we started with: there is not a great deal of spare capacity. Although there is a lot of uncertainty about the amount of spare capacity that exists, unemployment has dropped a long way and it cannot continue to drop. As constraints in the labour market intensify and firms find it harder to find additional skilled labour, that will—we hope—provide an impetus for them to rearrange their processes in a more productive and efficient way.

Similarly, we assume that monetary policy will start to tighten, albeit very slowly. One of the potential explanations of why productivity growth has been so weak is that interest rates have been extremely low, which has meant that firms have not been under pressure to improve their productivity because the servicing of their debt has been relatively straightforward. Interest rates have now started to go up, and, if they go up further, that too could provide some stimulus. Those are the main reasons why we have not chucked all our eggs into the “past 10 years: gloomy” basket.

As far as the policy response is concerned, the list of things that worthy reports on how to improve productivity growth say that we should spend more on does not change very much over time—it includes education, infrastructure, planning and so on—but it is always easier to stick such recommendations in a report than it is to implement them.

Willie Coffey: We know that we are in an extended period of austerity. Every year, most of us look—more in hope than in expectation, perhaps—for a change in the situation whereby the spending cut trend will reverse. Are you seriously saying that the austerity period is the new norm and that it will continue beyond the horizon that we can see? Is it the case that all that people in the public sector and elsewhere can expect is that austerity will continue to roll on in the same way?

10:00

Robert Chote: On cutting public expenditure as a share of GDP, the Westminster Government has set itself quantified fiscal targets for the size of the structural deficit—that is, the deficit that would be left if the economy were to get to a Goldilocks state that was neither too hot nor too cold—and is on course to achieve them in 2021 with a little bit of room for manoeuvre. That in itself does not imply an automatic need for greater austerity or greater fiscal consolidation than is already planned. However, the Government has also stated a longer-term, broader goal of getting the budget back into balance, and the date that it has put on that is broadly 2025.

Our formal forecasts do not go that far into the future but, on the basis of the forecasts that we have going to within a couple of years before that date, it does not look as though the Government is yet on course to achieve that broader goal. The deficit is still above zero and not on a clear downward trajectory right at the end of the forecast period. As we go into the mid 2020s, the ageing population will, if anything, put upward rather than downward pressure on public expenditure.

The conclusion that some people draw is that, if the current Government or future Governments are serious about balancing the budget, there is more fiscal consolidation to come on top of what is already in the pipeline. There are others who say that history suggests that Governments end up being content or at least living with a relatively small period of borrowing and that budget surpluses and balances are relatively rare. Therefore, what you expect to come out of that goal depends in part on how committed you think the Government will be to getting down to a completely balanced budget.

Willie Coffey: However, austerity will go on until at least 2025.

Robert Chote: It is clear from the numbers that we have already that the Government is relying on some continued squeeze on public expenditure as a share of GDP to deliver the further improvements in the budget deficit that is already in the book.

Patrick Harvie (Glasgow) (Green): Good morning. I will explore with you the implications of the uncertainty that you describe about what is happening with productivity—whether the past 10 years are the new normal or whether there will be a return to previous levels and the idea that people are splitting the difference in casting their projections forward.

Is the uncertainty about that puzzle resulting in any wider debate about what we measure when we talk about productivity—what productivity is—and what we measure it for? For the most part, we talk about it in relation to labour, but that does not necessarily tell us anything about whether the people who undertake that labour get the economic benefits of their economic activity. We could measure productivity in relation to, for example, sustainable resource use or other environmental thresholds on which most of the world now has a broad consensus about wanting to achieve.

Robert Chote: That debate has been around for a while anyway. There are two issues, one of which is the narrower issue about whether there are particular measurement problems. For a variety of reasons, let us leave aside whether GDP is the right measure to use. It depends on the question that you ask whether GDP is the answer. However, even if you ask a question to which GDP is the answer, there is debate about whether we are simply mismeasuring the output of the economy in a world that is moving away from the production of physical goods to a digital economy, for instance, and whether productivity is doing better than expected because we are not fully measuring output.

A related flipside of that is the question whether we were overmeasuring productivity in the period prior to the financial crisis, particularly in the financial sector. Maybe the difference is not as great as it appears to be because of the way in which statisticians try to capture value added in the financial sector.

There has been a reasonable amount of debate on both of those issues. The Bank of England has undertaken analysis, and my colleague at the OBR Charlie Bean has considered them as well. The general consensus is that the mismeasurement may be part of that story but it is hard to imagine that it explains a large part of what is now a 20 per cent-plus shortfall in the level of productivity relative to what would have been anticipated.

Patrick Harvie: When the Scottish Government talks about growth, it talks about “inclusive” or “sustainable” growth instead of talking about plain vanilla GDP growth. We could debate how successful that attempt has been, but the attempt has been made. Would there be value in the Scottish Government taking a different approach or cutting through the problem from a different angle in order to understand growth differently by using a measure of productivity that relates to other factors?

Robert Chote: The measure that you use depends, in part, on the question that you want to answer. As you said, in addition to the narrow issue of forecasting the outputs of the market economy, it is important to think about wellbeing more broadly and to bring into account environmental and distributional issues as well.

That is not an area that the OBR goes into—it is not really part of our remit, although I looked at it a bit more when I was at the Institute for Fiscal Studies.

I am slightly wary of saying that there is a perfect single index number that allows you to capture all those things and of saying that GDP is not a very good index number but that there is a much better one that captures all those things. The nature of the broader policy questions that you are describing requires you to look at a number of different indicators rather than pretend that you can boil them all down into one alternative number—that is my guess. That is not to say that all those policy questions are not valuable, but I am not sure how helpful it would be to have a single magic number against which you can say, for example, that overall wellbeing is up 0.3 per cent this year, taking into account all those factors.

Murdo Fraser: Good morning. You talked earlier about the forecast for GDP growth in Scotland and in the UK as a whole. You have downgraded your forecast for the UK. The Scottish Fiscal Commission has also downgraded its forecast for the rate of Scottish growth, which is now forecast to be substantially lower than the rate of UK growth. That is a continuation of a trend that we have seen for about the past three years, with Scottish GDP growth lagging behind UK GDP growth. You have also downgraded your productivity forecasts, and productivity in Scotland is forecast to grow at a lower rate than that of the rest of the UK.

Notwithstanding all of that, the Scottish Fiscal Commission expects income tax revenues per capita to grow at the same rate in Scotland as in the rest of the UK. Do you agree with the Scottish Fiscal Commission's conclusion, and do you have any comments about how it arrived at that conclusion?

Robert Chote: I do not know how much weight the Scottish Fiscal Commission would place on this, but we did not have the chance to take into account whether the implications of the latest set of proposed income tax changes would, in making the system more progressive by having higher rates at the top end, lead us to expect greater fiscal drag over time. As we return—we hope—to a situation in which earnings growth proceeds ahead of inflation, you could end up pulling more income into higher tax bands, with more revenue coming from those higher tax bands as a result.

It is striking that our November forecast and the Scottish Fiscal Commission's December pre-measures forecast are really quite close. There is a difference of just over 1 per cent at the end of both of our forecasts, which compares to a difference of about 8 per cent between our March forecast and the preceding Scottish Government forecast. Reasonable people can differ even over 8 per cent—I do not want to overstate the importance of that difference. Nevertheless, as you point out, the latest forecasts are rather closer.

In part, we are taking different approaches to modelling things. One thing that complicates matters is not knowing what the Scottish receipts have been over the past two or three years, although we and the Scottish Fiscal Commission assume that the percentage differences for those years are larger than for any of the forecast years. At the moment, outturn data based on Her Majesty's Revenue and Customs flagging up Scottish taxpayers as such is absent and we rely on the survey of personal incomes to do that. We and the commission used the 2014-15 survey of personal incomes data as a baseline.

The Scottish Fiscal Commission took the estimate of the Scottish receipts at that point, looked at its model of what developments in the Scottish economy would imply for the path of receipts and drew the line accordingly in order to forecast where we would be today and where we would be in five years' time. We took a slightly different approach. We were slightly surprised that income tax receipts were stronger in 2016-17 than the original data suggested they would be. Part of the story is presumably that financial sector bonuses came in more strongly at that time, which provided a stronger starting point. We are more optimistic than the commission about how much Scottish income tax receipts have been over the past couple of years—we are talking about differences of 3 per cent compared to just over 1 per cent later on. That slightly complicates the picture that you are looking at.

However, as I say, I do not know what difference we will assume the newly announced measures here will have on the growth of receipts in Scotland. I know that you have had a lengthy discussion with the Scottish Fiscal Commission about the difficulties in assessing behavioural impact and, therefore, how much of the static increase in revenue that you would expect from the measures that you are considering will be lost as a result of behavioural responses.

Murdo Fraser: Looking at the relative projected and historical growth of the Scottish economy compared with that of the UK economy, what major factors do you think cause the Scottish economy to lag behind the economy of the UK as a whole?

Robert Chote: On the basis of the commission's projections, the largest difference is population growth—that is, there is a bigger difference in the projected growth of overall GDP than there is in the projected growth of GDP per capita. Population growth is weaker in Scotland than in the rest of the UK, which reflects differences in the natural growth in the population, such as the fertility rate—

Murdo Fraser: Is that a historical problem? Does that explain what has happened over the past three years, for example?

Robert Chote: The much longer-standing issue is that population growth has been weaker in Scotland than in the rest of the UK—you will be the experts on that—because of smaller, more mature families and weaker migration periods, which might account for a chunk of that difference.

As I say, the Scottish Fiscal Commission is forecasting a trend of somewhat weaker growth in productivity over the next few years. It has had to do the same exercise for the Scottish data as we have had to do for the UK data, which has been to judge how much weight to place on each of those two very different periods of performance.

If you were to look at 2016 on its own, you would see that productivity growth was weaker in Scotland than it was in the UK. In the adjustments that we have made to our March forecast and that the commission has made relative to the Scottish Government forecast that it inherited, the question has been much more about taking a step back, looking at the historical picture and asking whether we really are in the right place than about placing too much weight on what has happened over the past few quarters. There have been occasions when we have thought about making adjustments but the most recent data has shown things to be picking up quite nicely. Alas, to date, those dawns have turned out be false ones and the improvement has fallen back. Perhaps, now that we have made the adjustment, this will be the point at which everything goes off to the races. Let us hope that that is the case here as well as in the rest of the UK.

10:15

Ivan McKee (Glasgow Provan) (SNP): I want to touch on the population issue, but, picking up on earlier contributions, I also want to ask about issues around the productivity puzzle.

We have just talked about the differential population growth figures, and I was interested in the use of the word "historical" in that context. Of course, the differential population growth between Scotland and the UK has been a problem for 300 years, not just three years: 300 years ago, the Scottish population was more than 20 per cent of that of the rest of the UK, but it is now 8 per cent, which shows that this is not a short-term issue.

With regard to what you have said about your projections for UK growth, your previous forecast was based on a figure of 185,000 for net inward immigration from the European Union into the UK, and your latest one is based on a figure of 165,000. Clearly, that has an impact on growth. Looking back to the pre-Brexit forecasts, and the reality of population growth based on net inward migration of 300,000 plus, what is the difference in terms of the population growth between where we were before the Brexit vote and the situation in which your forecasts hit the figure of 165,000?

Robert Chote: We do not do population projections ourselves. Like the commission, we choose from the variety of variant population projections that are produced by the Office for National Statistics.

When we made the first set of forecast adjustments after the referendum, we used the principal population projections that have been produced by the ONS. The ONS projections are not a sort of detailed assessment of the impact of particular policy settings; they involve a more mechanical exercise that basically assumes that, in the short term, net inward migration is going to be like it has been in the relatively recent past, but it also goes five years ahead to come up with something that is more like a longer-term average. There has therefore been a tendency for those projections to show a rate that is relatively high to start with and declines into the future.

As you said, we had been seeing net inward immigration numbers that were considerably higher than we had been assuming they would be. In the absence of the Brexit vote, we would have moved from the principal projection to a higher one—another mechanistic one produced by the ONS. However, the judgment that we took at the time of the November 2016 forecast was that, rather than raising our inward migration figure, we would leave it where it was and would simply set out what difference not making that change would make to the figures relating to the growth in the public finances.

The figure has dropped in the most recent forecast because the ONS has updated the principal population projection, and the latest numbers have moved the figure in that direction. It is fair to say that, at the moment, it looks as though actual developments in population appear to be moving more in line with the ONS's principal population projections than they had been previously.

When we made the adjustment at the time of the referendum, it was partly based on the view that—although we were not going to try to predict the precise outcome of the Brexit negotiations—the migration regime would be more restrictive rather than less restrictive, which was one reason to assume less net inward migration. However, the other thing that is happening at the moment concerns the pull factors—that is, in the absence of any policy change, there is a natural tendency for fewer people to come to the UK in the wake of the Brexit vote than would otherwise have been the case. That could partly be down to the fall in the exchange rate and the consequent reduction in the value of someone coming here to work in order to send money home, for example.

The immediate Brexit adjustment was not to move to a higher population projection but to stick with the principal population projection. The change in the most recent forecast is a result of the fact that the ONS has revised the principal population downwards. The commission is using an alternative projection that assumes less EU migration, too. That is quite an interesting factor to consider, but my sense is that, quantitatively, it does not make an enormous difference.

If you think about what has affected the commission's GDP growth forecasts over the next five years relative to the Scottish Government ones that it inherited, you can see that population and productivity are more important. Migration and the different view on the amount of spare capacity that you are starting with are material factors, but are less important than the first two.

Ivan McKee: In terms of the pure numbers, what impact has the change in projections had on your GDP growth number, with predicted net inward EU migration down from 185,000 to 165,000?

Robert Chote: The judgment that we would have made—

Ivan McKee: I think that it is a reduction of 0.2 or 0.3 per cent.

Robert Chote: That sounds about right.

Ivan McKee: I think that it is of that order.

Robert Chote: Yes—a reduction of 0.2 per cent by 2021-22. Having just looked at the paragraph in the report, I should make another important reminder: It is not just about the net inward migration number; it is also about the projected age composition of those making up the net inward migration, which looks less favourable to growth than the previous version did. It is not just the number that is lower; the projected proportion of those who are of working age is lower as well.

Ivan McKee: Okay. The forecast that the SFC has used, as you said, is a more conservative interpretation of the ONS's numbers, and that is one of the principal reasons why its growth forecast for the Scottish economy is lower.

Robert Chote: I think that describing it as one of the principal reasons would overstate its importance. I do not have the equivalent of the 0.2 per cent number for the SFC, but I think that that factor would be, by some way, the third or fourth largest factor, after productivity and population. Population as a whole is clearly an important factor; the specific difference between our net inward migration forecast and the SFC's net inward migration forecast is a small part of it.

Ivan McKee: Yes, but the key point is the difference between where we were pre-Brexit and where we will be.

Robert Chote: How much the SFC's choice of regime is down to a specific view on where we end up in terms of the migration regime and so on, I do not know. From our point of view, we have been very clear, across the forecast as a whole, that we are not basing it on a particular, well-defined prediction of where all these negotiations will end up in terms of trade access and migration regime—

Ivan McKee: You have picked a number.

Robert Chote: It is a broad-brush adjustment, but the direction is clear.

Ivan McKee: I am not an economist, so you can help me through this. Based on contributions that we have had before, my understanding—leaving aside Patrick Harvie's valid points on whether productivity and GDP are the right things to measure—is that productivity is basically, in mathematical terms, a calculation of GDP per hour worked.

You are basing your assessment of potential GDP on the fact that productivity growth is low, therefore the potential in the economy for GDP growth is constrained to some extent. If you dig into the maths of that, you see that GDP is consumption, it is investment, it is Government spending, and it is the difference between import and export. My point is that we tend to think of productivity as people working harder, but in reality, when you dig into the maths of it, you see that it is all about the GDP number, which is about how much people are spending, how much the

Government is spending and how much is being invested.

Is there an issue to do with the fact that we have been in an environment where real wage growth is low, therefore people are not spending as much and the consumption number is down, and the Government has not been spending as much because of austerity, therefore the Government spending number is down, and that those things are a drag on GDP? To some extent, it is not that GDP is constrained by productivity growth—it is the other way round. Is there something in that?

Robert Chote: Causality can go in both directions. You are right that you can think about the underlying potential of the economy—the level of activity that you would get to if you assume that the Bank of England is getting demand in the economy to the point that is consistent with keeping inflation steady, or the Goldilocks point, as it were. In terms of demand, we are talking about exactly the kind of things that you describe. It is about the mixture of different types of spending—consumer spending, business investment, net exports, stock building and so on.

I would be wary of the argument that the dominant direction is that weak demand has driven weak productivity growth. One way to restate the productivity puzzle is this: why have firms felt the need to hire so many more people to produce not very much more stuff? If demand had been greater—if the amount of spending power in the economy had been greater—would that puzzle have gone away? If demand has been weak and economic activity has been weak, why have we employed so many more people? That is the puzzle.

The fact is that, for the given amount of economic activity that there has been, an awful lot more of it has shown up in falling unemployment and rising employment and less of it has shown up in either output per worker or output per hour worked. There is an interesting debate about which of those is better for broader social consequences. Would you rather have a productivity puzzle or a much larger rise in unemployment for a given increase in economic activity? Some people would say that we should go back to the 1980s model, where more of the pain of weak economic activity was focused on a relatively small number of people who were unemployed—or on the margins of being so and fearful of being unemployed—and some would say that we should have what we have had instead, which is not a huge rise in unemployment but weak wage growth in the public and private sectors. There is a value judgment to be made—it is not for us to make it—as to which of those is better. In terms of the long-term implications for living standards, we worry about productivity growth, so it seems sensible to have that as the overall constraint. As I said, the puzzle is this: if demand has been weak and economic activity is weak, why have we employed so many more people?

Adam Tomkins (Glasgow) (Con): Good morning. My question is, I think, completely unrelated, and moves to a different area of the Scottish Government’s proposed budget. One of the most eye-catching features is the restructuring of income tax. I will ask about the structure in the UK and Scotland. The UK has had three bands of income tax for quite a long time, which have been set at thresholds that are quite far apart from one another. The rates are significantly different, moving straight from 20p to 40p. The Scottish Government’s proposal is to replace the three bands of income tax with five bands, three of which will be very close together at 19p, 20p and 21p. Never mind where we set each rate—is the restructuring likely to have any consequence, positive or negative, on the Scottish economy? Is there an economic management reason why we have had a smaller number of income tax bands spread quite far apart for 30 or 40 years? In the thinking of professional economists, is there such a thing as an optimum number or distribution of bands? Are there any issues that we need to worry about with regard to the proposed restructure?

Robert Chote: As you say, the mainstream economic view would be that those rates are very similar—one percentage point apart in the bottom three bands, at 19p, 20p and 21p—so the differences between the rates at that level would not be large enough to have an enormous implication for the shape and structure of economic activity.

There is clearly an issue, which I presume the Scottish Government has thought about. The desire to have more bands at the bottom presumably reflects that it thinks more bands will help with particular distributional objectives and, maybe, particular work incentive objectives. It may also have the view that, although the bands are close together now, it may want the flexibility to have them further apart in the future, so it is laying the groundwork for that—I do not know whether that issue has arisen at all.

The creation of new bands is likely to impose some sort of administrative costs on HMRC and the businesses that will have to adapt their payroll to deal with them. I suspect that creating a new band involves a greater administrative cost than simply changing the rate in an existing band, but I have no idea what the quantitative significance of that cost is. I do not know whether any regulatory impact assessment or equivalent has been done for the implications of that change. However, it will clearly require some work for firms with workers in that band of salaries and wages to adapt their payroll to be able to cope with it. Whether that is a significant burden is not something that I am expert on. You need tax practitioners to answer that question.

Adam Tomkins: Who should we expect to do that regulatory impact assessment? Does it fall within the brief of the OBR or the SFC?

Robert Chote: It is not something that we would do for an equivalent UK change. If we thought that you were doing something that was likely to change business behaviour at a macro level, we might think about that. However, changes of that sort in the UK context are generally accompanied by a regulatory impact assessment or some assessment of the costs imposed on businesses and consumers. I do not know what the arrangements are here for that and whether it is done or not, to be honest.

The Convener: No one has indicated that they have more questions. During your opening statement, Robert, you said that this is the second year in a row that you have been our first witness of the year. That has probably been to our significant advantage, because you are able to deal with detailed and complex issues in such a simple manner.

Robert Chote: It gets you off to a cheerful start.

The Convener: It is also about the realism that you bring to it all, which is very refreshing. I thank you for that, and we might do the same to you again next year.

Robert Chote: Thank you very much. It is my pleasure.

The Convener: Thank you for giving us your time.

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

10:31

Meeting suspended.

10:38

On resuming—

The Convener: Welcome back, colleagues. The second item on the agenda is to take evidence on the Scottish Government's draft budget for 2018-19 from Derek Mackay, Cabinet Secretary for Finance and the Constitution. We will concentrate on revenue issues today, but we will turn more to issues around the constitution at our meeting next Monday in Aberdeen—sorry, I mean the expenditure, not the constitution.

The Cabinet Secretary for Finance and the Constitution (Derek Mackay): You are obsessed!

The Convener: I have been obsessed by the constitution and clause 11 of the European Union (Withdrawal) Bill for too long.

Mr Mackay is joined by Scottish Government officials Aidan Grisewood, deputy director of the fiscal responsibility division; Simon Fuller, deputy director of the economic analysis office of the chief economic adviser; and Andrew Chapman, team leader for fiscal delivery and constitutional change—it was obviously your fault, Andrew, that I said "constitutional".

Cabinet secretary, this is an interesting time, when you have proposed new—sorry, do you want to make an opening statement? That might be a good place to start.

Derek Mackay: That would be helpful, convener. You can then open it up to committee members to ask questions.

I wish all the committee members and officials a happy new year. This is indeed an interesting and exciting time in terms of the use of our devolved functions and powers. It has undoubtedly been an uncertain and turbulent time internationally.

In composing the draft budget, I have tried to deliver stability and stimulus and sustainability for our public services. In very challenging circumstances, the draft proposals reflect our determination to use the powers to grow our economy, to build the fairer Scotland that we want to invest, live and work in and to support our public services.

Supporting our businesses to develop and thrive is a key part of that. Taxation proposals are of course central to all that—they are about raising the necessary revenues to enable us to invest in our society and public services.

The budget outlines the spending plans and the revenue plans. I hope that it has taken into account and responded to some of the recommendations of the budget review group and this committee about presentation.

I turn to the key features of the draft budget this year. Underpinning the budget is the new role of the Scottish Fiscal Commission in producing its independent forecasts for the economy. Whatever any of us might think about any element of the commission's forecasts, they underpin the budget and we are therefore reliant on them in respect of tax revenues and social security spend. I thank the commission for its work and engagement over the period.

The committee has taken much evidence during its inquiries from members of the commission and its chief executive and others on both forecasts and methodologies. As I said, the forecasts are not just a matter of the commission's opinion; they relate to the block grant adjustment and the OBR forecasts, which underpin our budget numbers. The most substantial income lever is income tax, which now accounts for more than £12 billion. HM Treasury releases the funding on the basis of those forecasts and revenues.

The second major innovation in the budget this year is in how we propose to use those income tax powers. It was helpful that we had engagement with civic Scotland and others when we published the discussion paper on the role of income tax in Scotland's budget. It was good practice to engage in that fashion and to set out the principles that the Scottish Government supports and how we will deploy the income tax powers to protect lower-income earners, support public services, protect the economy and use the tax system in a progressive way. Whatever the difference of opinion on the outcome of that discussion paper, we can take great heart from and have great confidence in the competence of the paper's impartial analysis of the political parties' propositions. That consultative approach with civic Scotland has ensured that we are prepared to implement our income tax powers and any changes competently and effectively, having given as much notice as possible.

Members of the committee will be familiar with the budget's draft proposals, but I will re-emphasise some of the key ones. The income tax proposals will mean that 55 per cent of taxpayers—those earning up to £26,000—will pay less tax than they would elsewhere in the UK, making Scotland the lowest taxed part of the UK for the majority of taxpayers. I would argue that it makes it the most fairly taxed part of the UK, with the best deal in terms of expenditure and entitlements.

Having carefully considered all available evidence on market performance and forecasts, I propose to keep the rates and bands for land and buildings transactions tax as they are at present. I have, however, proposed the introduction of a first-time buyers relief, which would have the effect of raising the zero-rate threshold for first-time buyers to £175,000.

I have also set out our proposals for Scottish landfill tax rates. They will rise in line with inflation and continue to match rates in the rest of the UK.

10:45

On business rates, we will provide the most competitive reliefs package in the UK. It will be worth a record £720 million, up from £660 million in 2017-18. It will also include several measures unique to Scotland to stimulate and support business growth, such as the growth accelerator and proposals to delay rates liability until occupation for new buildings, as well as supporting the small business bonus scheme, which should lift more than 100,000 properties out of rates altogether. Of course, the number 1 ask of business was to move to the consumer prices index from the retail prices index for business rates poundage uplift.

As the committee would expect, the proposals have been considered in great detail and in conjunction with the Adam Smith principles of efficiency, certainty, proportionality and progressivity.

I am happy to take questions on the revenue aspects of the budget.

The Convener: Thank you, cabinet secretary. As you say, it is an interesting time. You have proposed new rates and bands for Scottish income tax. Your budget is now much more dependent on the performance of the Scottish economy relative to that of the UK economy. Will you give the committee some insight into how you have changed the Scottish Government's approach to the draft budget this year and your plans for future years?

Derek Mackay: It is fair to say that all politicians in Scotland should always have been mindful of sustainable economic growth and what could be done to stimulate the economy, but there is now a closer focus on what needs to be done to support economic growth. That includes tax decisions and creating the right environment for economic growth. Part of that is absolutely about delivering quality public services and creating the kind of society that we want to live in—a fairer society—but we have arguably all had to consider that bit more closely what we can do to support economic growth.

The Scottish Government and ministers of all Administrations will always look to the best way to grow the economy, but there is now an added reason to do it because it affects the resources that we will have to spend on public services in Scotland. Therefore, there has been an even stronger focus on economic spending, economic and industrial interventions and a tax environment that takes a balanced approach to grow the economy stably. In approaching how we spend and raise resources, we have to ensure that we are mindful of economic growth.

I am sure that, because there has been much commentary, there will be questions on the forecasts for Scotland, but we could argue that that has led to an even stronger emphasis on economic interventions and business support. However, the working-age population and migration are arguably an even more substantial factor than that. They are a critical factor in the economic success that Scotland will enjoy. Perhaps that relates back to the constitution after all, but it is clearly a determinant in the economic forecasts that the SFC and others have set out.

Economic growth is absolutely front and centre in ministers' thinking because, if we do not make the right decisions on the economy, we will naturally have fewer resources to spend on our public services.

The Convener: There has also been some commentary on the budget settlement from the UK Government, with claims that it has been increased and counterclaims that the resource spending has been cut in real terms. It would be useful to the committee for the Scottish Government to put on record what it understands the position to be.

Derek Mackay: The interpretation of resources is becoming an annual ritual between Mr Fraser and me, with others then playing in. It is a feature of the budget, so why change it?

My fundamental point is that, if we play in real-terms increases, the difference between resource and capital spending and financial transactions, over the 10 years from the spending review in 2010 our overall resources have gone down by about 8 per cent in real terms, which is a £2.6 billion reduction.

Let us take one year to the next, because I suppose that people are most interested in that. Going into financial year 2018-19, I welcomed the resources on capital and on financial transactions, but I made the point that, in resource spending, there is a £211 million reduction between 2017-18 and 2018-19 and a £500 million reduction over two years. I make that distinction because that is the fiscal resource that we have available to fund our front-line services, whether they are in the health service or other front-line services. That is the key point. That has been most severely affected by the UK Government's spending decisions.

We can go beyond that and talk about the Barnett consequentials over a four-year period. The figure was £2 billion, but that was largely financial transactions. I welcome financial transactions, which we will use to grow our economy, but I cannot use them to invest in front-line public services such as school education delivery or hospitals. Over half of that £2 billion was financial transactions. Budgets are complex, but there has been a real-terms reduction going into 2018-19, which is why the Government proposes to turn a real-terms resource reduction into a positive real-terms increase by using our tax powers in the fashion that we have described.

The Convener: Thank you very much. I think that Willie Coffey has a question that will help to set the picture on issues that the cabinet secretary has mentioned relating to four key tests.

Willie Coffey: Good morning, Derek. In the tax discussion paper "The Role of Income Tax in Scotland's Budget", you proposed four key tests. You said that tax changes must

"Mitigate UK Government spending cuts ... Make the tax system more progressive ... Protect lower earners"

and

"Support economic growth".

Will you outline how you have managed to achieve those four aims in your proposals and illustrate what you have done in each of those categories?

Derek Mackay: I believe that we have held true to those four tests, but I recognise that the Government is in a Parliament of minorities and that a compromise on income tax will have to be found. Therefore, in approaching the issue, we wanted to create a transparent and engaging debate in advance of decisions being taken on income tax that recognised that there were options in changing the number of bands, thresholds and rates. It was right to take that consultative and collaborative approach with stakeholders in advance.

In setting out the tests, we tried to give a degree of certainty about what we were trying to achieve. One test is to ensure that our decisions do not adversely affect the economy. A few weeks before I presented the draft budget, we convened an inclusive growth conference in Glasgow, which was attended by key figures from the world of academia, economists, and past and present finance ministers. It was important to set out progressive taxation in a way that does not adversely affect the economy. I was struck by the fact that the International Monetary Fund has said that progressive taxation does not necessarily affect economic growth.

I will set out how we have met all four tests. In protecting our public services, we have gone from a real-terms decline in that resource expenditure into real-terms growth. We are trying to raise extra resources to invest more in our public services.

We believe that we have protected lower income earners through introducing the starter rate. I have given figures that relate to those who will pay less tax. I am not going to say that there is a massive reduction—I do not want to overplay that—but there is structural change that will benefit a majority of people, primarily those who are lower earners. Therefore, we have protected those who earn less.

The tax system that we have proposed is more progressive, because it asks for a bit more from those who have more. That is the essence of progressivity. The system will take less from those who have less because of the introduction of the starter rate. The personal allowance issue is part of that, of course, and it can be taken into account. The structural improvement in the system to have five bands rather than three will also assist with tackling inequality and increasing progressivity.

That takes me to the final test of supporting the economy. You have seen the SFC report, which says that the commission does not believe that our tax decisions, when taken into account with the spending decisions, will have a net negative effect on the economy. Of course, it is just forecasting and modelling, but I think that the tax decisions then raise resources for investment in our public services and also for business and innovation. When we come to spending, I will talk more about the uplift in the economy portfolio or about the industrial interventions, skills interventions, support for higher and further education, the international hubs and so on. It is a balanced approach, but I believe that it has delivered those four tests in the way that I have described.

Murdo Fraser: Given your answer to the convener's second question, you would be disappointed if I did not pursue the issue of the size of the Scottish Government's budget, but I am not going to ask you about the overall size of the budget. I want to ask just about your discretionary spend, which I believe is your preferred measure. If we look at the block grant, is your discretionary spend either up or down in next year's budget compared with the current year's?

Derek Mackay: I have pointed out that, overall, if you include capital and financial transactions, it is up, but I have deliberately focused on resource, for the reasons that I have given.

Murdo Fraser: The Fraser of Allander institute said in its economic commentary in December:

> "the Scottish Government's total block grant (resource and capital but excluding financial transactions) is on track to increase by around 1% between 2016-17 and 2019-20."

Do you accept that that is correct?

Derek Mackay: Yes, I am not objecting to that. Everything that I have said so far is true. This is the exchange that we normally have, but I have focused specifically on resource, for the reasons that I have given concerning investment in front-line services. I have welcomed the capital and I have welcomed the financial transactions. I have also taken a 10-year view, because that is the timescale for the spending review periods.

Murdo Fraser: You say that you welcome the financial transactions. I remember that, when they were announced, you described them as a "con".

Derek Mackay: If I had a choice between £2 billion to spend on our front-line resource spending over financial transactions, I would take the resource spending, because I could spend it on health, education and other areas. Financial transactions are loans and have to be paid back to the Treasury. We can use them, and we will use them wisely, but I am afraid that they are not a substitute for enhanced discretionary resource spending, which, as Murdo Fraser knows, could be well spent by many parliamentarians, including Tories who would quite like to spend in that fashion.

Murdo Fraser: I think that we have accepted that financial transactions money is not a con, so perhaps we can agree on that point. I have just one last point on the question of discretionary spend. You quoted a figure of 8 per cent for the decline in discretionary spend since 2010. The Fraser of Allander institute briefing states that the discretionary spend decline is 3.8 per cent since 2010, not 8 per cent. Perhaps more significantly, it goes on to say:

> "It is debateable whether or not comparisons just with 2010/11 are appropriate. 2010/11 marked the year when the Scottish Government's RDEL budget was at its historic peak following years of significant growth. The 2017/18 RDEL budget in real terms is around that in 2007/08."

If we take the 10-year period during which the SNP Government has been in office, the amount of money that you have to spend today, in terms of the block grant, is roughly equivalent to what it was in real terms when you came to power 10 years ago. Over that 10-year period, according to the Fraser of Allander institute, there has been no real-terms cut. Do you accept that?

Derek Mackay: No, and I refer Murdo Fraser to page 7 of the budget document, which goes through the Treasury limits and the real-terms change that we have outlined using the figures. It shows a real-terms reduction from 2010-11 to 2019-20. As Murdo Fraser has covered the timescale issue again, it is worth pointing out that that is a period of successive spending reviews, so I think that it is an appropriate timescale. He has also pointed out some of the choices about growth that otherwise could have happened, and those are choices—a choice about austerity, a choice about controlling public expenditure—that the UK Government has made. Although you can take a view on that point, it remains the case that, if we had the same resources in real terms as what was achieved in 2010-11, we would be better off now fiscally and financially to the tune of £2.6 billion now. Think of the difference that that would make in our public services.

11:00

We can keep arguing about the past. That is fine. I can focus on the past. However, if we are looking forward, I have welcomed the capital and the financial transactions but the real-terms reduction in resources requires us to make difficult choices and to use our tax powers in a fair and balanced way. That is what I have proposed to make up for the decisions of the United Kingdom Government, and that is before we get into other financial disputes about whether it is real funding or the consequentials that we could have had if Scotland got a similar deal to the one that Northern Ireland got when the Government bought off the Democratic Unionist Party, or how other Barnett resources have arguably been bypassed.

Fundamentally, the trajectory from the Tory Government has not meant year-on-year real-terms increases.

Murdo Fraser: According to the Fraser of Allander institute, over the 10-year period of this SNP Government, there has been no real-terms cut in your resource budget. Is that correct?

Derek Mackay: No.

Murdo Fraser: So you are saying that the Fraser of Allander institute has got this wrong.

Derek Mackay: I am happy to rely on our officials and our statistics. Economists can have many different views, but I have shown Mr Fraser repeatedly that, when it comes to resource spending, there has been a real-terms reduction to Scotland's budget and the Fraser of Allander institute has also said so.

Murdo Fraser: Not since 2007-08. We are talking about different baselines.

Derek Mackay: Convener, I have tried to outline why the 2010-11 baseline is important.

The Convener: Okay. It is an interesting ding-dong.

Derek Mackay: It is the start of our new year.

The Convener: It would not be the same without it.

Ivan McKee: I am interested in exploring how the budget is focused on supporting business and growth in the economy. What work is being done in that regard? Perhaps you could take this opportunity to outline that in a bit more detail.

Derek Mackay: I would be happy to go into expenditure, convener, but I can tell that that would test your patience. However, on how taxation and revenue relate to business, our income tax policy is balanced. It raises additional resource for public services as well as for industrial and commercial intervention. However, despite what some people would gleefully argue—undermining Scotland—in terms of personal taxation for a majority of taxpayers, Scotland is now the lowest-taxed part of the UK and offers the best deal. That deal and the quid pro quo offer should attract people to Scotland.

The business rates policies are significant in terms of taxation and attracting and growing businesses. The Barclay review said that it would have recommended moving from RPI to CPI on the business rates poundage if that was affordable. I know that the review had a revenue-neutral remit, but the considerations and evidence that Ken Barclay and his panel were able to give me allowed me to develop that thinking further.

I argue that having the best package of business rates relief anywhere in the UK, particularly one that supports small businesses, is a significant element. There is more support for hydro and the particular interventions around the growth accelerator and no rates liability until occupation are unprecedented in the UK. That is important because the package is not about just making a tax cut for its own sake; it is about creating a genuine stimulus for businesses to make decisions to improve, expand and enhance property.

I will give an example. If a business wanted to make its property more environmentally friendly and create fewer emissions, it would probably end up paying more non-domestic rates as a consequence. The growth accelerator supports such interventions, and rightly so, because it gives a period of grace for non-domestic properties, so that there is a benefit from enhancement, improvement, new build or, indeed, speculative new build. All that puts the business at an advantage, which is helpful in making Scotland even more competitive.

Despite some politically charged commentary, most of the responses to the budget that I have seen have welcomed it as one that takes a balanced approach, including for business.

The Convener: Patrick Harvie has a supplementary.

Patrick Harvie: It is a brief one on non-domestic rates.

The Convener: Please make sure that it is brief, because I know that you have other questions that you want to ask later on.

Patrick Harvie: Good morning, cabinet secretary. You mentioned the fact that the Barclay review was given the remit of ensuring that its proposals were cost neutral. I might criticise the decision to undertake a review with such a narrow remit rather than a comprehensive review of local taxation.

Our briefing on the draft budget refers to the remit that was given to the Barclay review but says that the policy reforms that flow from the review will cost £96 million in 2018-19. Therefore, the proposals of the Barclay review are not cost neutral. We have had evidence from others who have suggested that, roughly speaking, the reduction in revenue from non-domestic rates takes up the majority of the extra revenue that you say that you will raise from income tax, which you say is for public services. Is that accurate? Will the majority of what you raise from income tax be given away in non-domestic rate cuts?

Derek Mackay: No. The figure that you have cited in relation to the cost of the Barclay recommendations is correct—it is approximately £96 million. Indeed, I have gone further than the Barclay recommendations.

The other side of Ken Barclay's report relates to the raising of revenue, but Parliament does not have the appetite to see through the recommendations that he made in relation to, for example, arm's-length external organisations. I concur with that view, but I make the point that Parliament is largely supportive of the interventions to support business growth—the enhanced reliefs and so on—notwithstanding the position of the Greens and perhaps the Labour Party. Overall, there has been a lot of support for many of the growth interventions that Barclay recommended on non-domestic rates, but there has been less support for the revenue-raising element. There might be more support for some of the smaller revenue-raising proposals, such as the proposal that independent mainstream schools should no longer have rates relief. I think that that is why there is a difference between what Barclay recommended and what has come out in the financial outturn.

That said, I think that the measures on non-domestic rates are necessary. In the past, a debate has been instigated about the Laffer curve.

Patrick Harvie: Not by me.

Derek Mackay: Certainly not by you. I am not even sure that Murdo Fraser would use Laffer curve analysis any more, in the light of recent commentary.

My point is that each tax must be considered on a case-by-case basis.

Patrick Harvie: But you are disputing what we have been told by others, which is that the non-domestic rate tax cuts will take up the majority of the extra revenue that will be generated from the income tax changes.

Derek Mackay: No. The overall policy decisions on income tax, taken together with the element of methodology change, will lead to an increase of £366 million in income tax. This year's budget proposals account for only part of that, but that is the total amount that will be derived from the Government's decisions on income tax. This year, £164 million will be generated as a consequence of our policy decisions.

I am simply saying that each tax must be considered on a case-by-case basis. It is true that Parliament has a choice—Parliament could say, "Don't spend £96 million on non-domestic rates relief," or it could ask the Government to make different choices. However, it is my position that substantial interventions such as the growth accelerator and the policy of no rates liability until occupation will lead to a stimulus in economic activity, particularly in relation to property, because Scotland has an advantage in that respect. Those interventions should lead to further economic growth.

Each tax should be considered on a case-by-case basis. Parliament can make choices, but I believe that we have struck the right balance between personal taxation to raise revenue and interventions on non-domestic rates to support growth in our economy and to respond to the Barclay report in a balanced way. However, it is true to say that the revenue-raising elements that would have helped to fund the expenditure elements of Barclay would not have the support of Parliament.

Adam Tomkins: Good morning, cabinet secretary. I want to ask you a number of quite detailed questions about the implications of your proposals on income tax.

A few moments ago, you said that you are using the Scottish Parliament's tax-raising powers in a "fair and balanced" way. According to the Scottish Parliament information centre's analysis of the proposals, those earning between £33,000 and £43,000 will pay more tax next year than this year, but those earning more than £43,000 and up to £58,000 will pay less tax next year than this year. How is that fair and balanced? What kind of behaviour are you trying to incentivise or disincentivise by giving those tax cuts and rises to those in the different salary brackets?

Derek Mackay: With some of the policy, we may not have set out to have that particular consequence. The point relates to the decision last year to freeze the higher-rate threshold. We do not propose to do that in the proposals this year; we propose to increase it in line with inflation. That creates what I have admitted is an anomalous situation, but resetting the tax structure in the way that we have done creates that anomaly. I have not set out to say that there must be a bracket that is treated differently. The situation stems from the structural resetting of the whole system, which introduces a new starter rate, has an intermediate rate, and has thresholds for the higher rate, which is increased in line with inflation. That creates an unintended consequence for a particular bracket.

If you look at the situation over a period of two years, you could argue that people in that bracket were not the beneficiaries last year, because the higher rate was frozen but they will benefit this year, because I propose to increase the higher-rate threshold. That is the reason for that outcome. It is anomalous, but that is what happens when we have structural resetting and increase the higher-rate threshold. That is the technical explanation for why that has come about.

Adam Tomkins: So it is an unintended consequence.

Derek Mackay: I did not set out to have a particular bracket that is affected in that way. It is an unintended consequence of resetting the whole system and proposing to increase the higher-rate threshold.

Adam Tomkins: I wonder what other unintended consequences are lurking in these tax plans. In your opening statement, you said that you were proud of the Scottish Government's engagement with civic Scotland during the autumn. What engagement have you had with the Treasury and with HMRC, to ensure that your tax plans do not have other unintended consequences with regard to, for example, the married couples allowance?

Derek Mackay: As Adam Tomkins would expect, I regularly engage with UK Government ministers. I assume that I will be dealing with the same ministers; I have not checked the latest status of the UK Government's Cabinet kerfuffle or reshuffle. I certainly got as much early notice of its tax proposals as possible—and, like me, members of this committee are all familiar with the issues around timescales and notice. The chancellor stands up and gives his budget and I then have three weeks in which to propose the Scottish budget.

Officials work constructively and engage positively, and HMRC has advised me, through officials, that it is satisfied that the changes that we propose to make to policy can be delivered and administered effectively. Of course, what it would like is as much notice as possible if there are to be changes, as good timing certainly helps. However, there is constructive engagement, as a matter of course, on the practicalities of the Scottish Parliament exercising its devolved functions competently.

Adam Tomkins: So can we—

Derek Mackay: I was going to come back to your other question. I assumed that you were interested in—

Adam Tomkins: Oh, good.

Derek Mackay: The fundamental point is that officials work together—I was going to say "harmoniously"; that might not be totally true, but they certainly engage constructively to make sure that the system works.

On the specific examples, there are a couple of areas that it is not in our gift to resolve. They relate to functions that are reserved to Westminster and administered by HMRC, and are unintended consequences of any divergence in policy. I argue that that is not a reason not to diverge on tax policy—anyone who believes in devolution would say that—and where there are any anomalies, we would expect the UK Government and HMRC to support that.

11:15

Officials have engaged with HMRC on that specific issue. If any changes are required, I would encourage the UK Government to make them to ensure that there are no unintended consequences. Essentially, the position is not settled yet, because HMRC continues to work on the issues, but it is now familiar with our policies and should, I hope, address any unintended consequences where they have arisen.

It might be helpful for officials to say more about the technical detail behind the marriage allowance.

Aidan Grisewood (Scottish Government): On the specifics, the discussion paper is very helpful for early engagement with HMRC on potential scenarios. It gives them a heads-up on where we are going without necessarily sharing a precise policy with them, since it would obviously not be appropriate to share that in advance of the budget.

We have already specifically engaged with HMRC on the marriage allowance, post-budget. As the cabinet secretary said, that is a reserved matter. The intention is to make sure that the issue is resolved—

The Convener: Sorry—I do not know about other members, but I do not know what needs to be resolved. Can you explain the issue so that we know what you are trying to resolve?

Aidan Grisewood: At present, basic-rate payers who are married are entitled to a relief of a maximum of £260 for 2018-19. As a consequence of the structural changes, a question arises around the intermediate rate that has been set—the 21p rate—and there is also the fact that the higher-rate threshold is lower than the UK equivalent. The question is whether we stick to the letter and have the marriage allowance only for basic-rate payers, which means that people on the intermediate rate lose that entitlement, or take a pragmatic approach that avoids that eventuality.

We are working closely with the UK Government on the issue. We understand that a minor legislative change could be put in place that would correct the issue. Again, it is in the UK Government's gift to take that forward.

There are those who say that this is early engagement post decisions being made, but there are potential solutions to avoid that outcome.

Adam Tomkins: What is the policy intent? Is it for people in Scotland who are on the new intermediate rate to lose their entitlement to the married couples allowance or not?

Derek Mackay: No. It is a policy that we do not control, but we can express a view on it. My view is that Scottish taxpayers should continue to have that entitlement. It is back to the Westminster Government to make that change—or not. It would not lose out by making it, because that would provide continuity. I make the point that it is one of the anomalies, but it is not a reason not to diverge on income tax policy. The maximum relief is £260 per couple for those affected, and if the UK Government wished to do so, the issue could be resolved in advance of the new financial year with a minor technical change.

Adam Tomkins: If you foresaw the problem before you presented your budget proposals to Parliament last month, why did you not seek to resolve it with HMRC before coming to Parliament?

Derek Mackay: I think that Mr Grisewood said that we engage with HMRC. Apart from the SFC—for obvious reasons—the first to hear the tax policy that I propose is Parliament. There are discussions of scenarios and engagement on potential anomalies in advance, and there is engagement with civic society. Helpfully, in civic society there are tax experts such as the Chartered Institute of Taxation and the Institute of Chartered Accountants in Scotland that voluntary raise with us issues that they foresee. We take those on board, work on them and engage with relevant agencies.

My point is that the budget is out for consultation. That is the purpose of this committee appearance, and we will engage further with HMRC. It is then for HMRC to ignore the anomaly or resolve it.

The question that I put back to Mr Tomkins is whether he would say that we should not use our devolved powers and should not have divergence because the outcome would be some unintended consequences. We hope that HMRC will resolve any unintended consequences. I do not see any reason why it would not do that. Then it will be back to Westminster politicians to respect the fact that we have devolved powers and should be free to use them.

Adam Tomkins: My view is that devolved powers should be used after you have done your homework and have thought about the consequences, so that they are intended and not unintended. I will move on to—

Derek Mackay: That is not a fair characterisation. I made the point that the situation was not a surprise to us. We engage on such matters, so there can be no suggestion that we have not prepared for such anomalies.

It is not within our gift to resolve the issues, but it is within Westminster's gift to do so. Westminster should respect the fact that the Scottish Parliament is exercising its devolved functions in the spirit of Scottish democracy. It is for the Scottish Parliament to decide whether we use the powers, not Westminster.

Adam Tomkins: Okay, but on the substance of the married couples allowance, you cannot give us an assurance that people on the intermediate rate will not lose it. I want to move from that issue to—

Derek Mackay: I cannot give you an assurance that Westminster will see sense and ensure that the devolved powers in Scotland are exercised fairly. However, I have found that Westminster has been willing to take a constructive approach on many other matters relating to the budget. I hope that it will take a constructive approach on this matter, too.

Adam Tomkins: What about pension lump sums? Tax reliefs are available. How will pension lump sums work through, given your proposed restructuring of income tax?

Derek Mackay: On tax relief, I make the same point, which is that that is a matter for HMRC. Why make an overall point about pensions, which is an issue that has been referred to elsewhere? Again, where there are relief anomalies, it is for HMRC to address those, knowing what our tax policy is and what our intended policy outcomes are.

On pension lump sums, I argue that our progressive tax policy would benefit most pensioners. Pensioners who work would pay into a progressive tax regime. Pensioners who draw down a lump sum would be in a more progressive situation, too. From the evidence and information that I have seen, most people who draw down a lump sum do so at the lower end, so they should benefit from the more progressive rates that are proposed in the income tax policy.

Pension lump sums are a significant issue but, as I have said, the majority of pensioners would benefit from a progressive tax regime. I will make a point about the inadequacy of the devolution settlement: we do not control every element of the tax system—we do not control tax reliefs and national insurance contributions. If there are anomalies, that does not mean that the Scottish Parliament should not exercise its power over income tax; rather, it suggests that we should have all the powers over income tax, national insurance contributions and so on, so that the system can be far more harmonious.

I welcome the fact that we have this substantial income tax power, but if anomalies arise from our not having control of other parts of the system, that suggests that we should have full control over them.

James Kelly: I will pick up on a couple of points that have been raised. You said that a principle of the taxation changes is that they should offset austerity. Patrick Harvie questioned you about the overall amounts that will be raised through income tax. You will be aware of the Fraser of Allander institute's analysis, which clearly demonstrates that—as you have stated—£164 million more will be raised. However, when the business rate offset, the LBTT change and the support for carers allowance are taken into account, only £28 million will be available to meet the challenges of, and to offset, austerity—not to mention to fund the Government's public sector pay policy. Therefore, the analysis shows that you have produced a weak set of tax proposals to meet the challenges that you have set yourself.

Derek Mackay: No. As I have described, I have tried to deliver a balanced budget that supports the economy, protects and invests in our public services, and lifts the public sector pay cap. If I were to be asked whether the budget is pro-business, I would say yes. It is also pro-public services, pro-sustainable economic growth and pro-national health service, with a higher-than-inflation increase for the NHS.

I think that, for the reasons that we gave at the start of this evidence session, growing our economy is the right thing to do, as is striking a balance on tax and using our tax powers in a fair and progressive way to raise extra resources. The decisions that the Government has taken this year and last year specifically around income tax result in an extra £366 million for expenditure on our public services. We have done that in a balanced way.

Whatever we think of the Scottish Fiscal Commission's forecasts, they underpin our budget and, in taking the tax decisions, I have tried to ensure that we meet the four tests that I described to Willie Coffey.

I think that it is a balanced budget. It is one that will protect our public services, invest in a fairer society, protect the country from the welfare reforms of the UK Government as best we can and invest in the future, which includes investing in infrastructure. Therefore, I do not accept the charge that Mr Kelly has made.

James Kelly: How can you say that it is a "pro-public services" budget when the evidence shows that, when you work through the tax changes, only £28 million will be available to offset the impact of austerity and cuts?

Derek Mackay: I can say that because of the decisions that the Government is taking. We are investing at above-inflation levels in the health service and we are lifting the public sector pay cap. We are, I believe, protecting local government in terms of resource and capital and we are making record investment in housing to meet our affordable housing target. We are making new interventions in relation to broadband and we are mitigating welfare reform. All that will be achieved by the budget. I can say that is a pro-public services budget because it will achieve all those things and more.

James Kelly: I submit that it is highly questionable that the budget could be considered to be pro-public services when the amount of money that will be raised that can be allocated to offset the public services cuts will be only £28 million.

Adam Tomkins raised the issue of people who earn between £43,525 and £58,500 paying less tax. Were you aware of that when you published your budget?

Derek Mackay: Yes, and we were up front about that in the press briefing. I am aware of that anomaly and I have explained it. I did not set out to treat a band of taxpayers differently, but that is a consequence of the proposal to lift the higher-rate threshold as part of the structural resetting. Over the two-year period, people who were not beneficiaries of the outcome last year will be the beneficiaries this year. So, no, Mr Kelly—it was not a big secret.

James Kelly: Understandably, people are looking at this year's budget. Do you think that people will view it as inconsistent that people who earn £42,000 will pay £90 more in tax while people who earn £55,000 will pay £35 less? Is that approach not inconsistent with some of the principles that you outlined earlier?

Derek Mackay: I think that, by definition, an anomaly is inconsistent. I make the point that we are resetting the tax system and making structural change in a way that will deliver a fairer system overall. We are addressing the fact that it is normal to increase thresholds in line with inflation—it is a choice, but it is normal to do that.

Of course, we have to abide by the SFC forecasts, but I believe that we have delivered a system that will raise £164 million more and which is fairer and more progressive. It will not adversely affect the economy and will ensure that, for the majority of taxpayers, Scotland is the lowest-taxed part of the UK. It will ensure that 70 per cent of taxpayers pay less, not more, based on the fact that those who will pay more have more money. Along with the policy choices that we have made, it will contribute to developing a better and fairer society. Structural change has resulted in the anomaly that James Kelly mentioned: it is the result of the overall restructuring of the tax system, in which we are introducing two new bands.

James Kelly: Is not it the case that the tax changes are, rather than being progressive, weak and incoherent? They are weak in that they will raise only a minimal amount of money to offset public services cuts, and they are incoherent in the inconsistency of the tax rates and changes that are proposed.

11:30

Derek Mackay: To be fair—I am sure that Mr Kelly wants to be fair—I say that tax is a very complex area. I have covered some of that complexity this morning. Such a substantial change to reset the system will have complexities within it.

I say frankly that I do not know of any commentator or economist who has said that the proposal is anything other than progressive. A politician may argue that it does not go as far as they want, but there is consensus that the proposal is competent and constructive, and that engaging in advance in order to iron out issues and to hear from people—trade unions, the business community, taxation experts and others—what they think has been a good way to do policy. Everyone agrees that the proposal is progressive; how far to go is a matter for others. I argue that the proposal is a major step towards delivering a fairer structure, and that the rates and thresholds within it are fairer. It is certainly better than our previous structure.

The proposal will raise extra resource for Scotland's public services. It is, of course, at the discretion of Parliament how those resources are spent. Taken together, the decisions for the past year and this year have amounted to an increase in the resources that we will have to spend. It is interesting that the Fiscal Commission's current forecast suggests that income tax will continue to rise in Scotland. Even if GDP does not have the same rise, wage growth will match that in the UK and income tax receipts in Scotland should be in a stronger position.

Emma Harper (South Scotland) (SNP): I am interested in how the structural changes that you have described will benefit people. In the first three tax bands, many employees are women—89 per cent of nurses are women, most healthcare support workers are women and most people in the caring community are women. The draft budget directly reflects the Scottish Government's equalities agenda. Will you describe the further benefits of the first three tax bands, and was there a conscious decision to include women?

Derek Mackay: There was equalities thinking when we composed the budget, in respect of both revenues and expenditure. It is fair for Emma Harper to say that delivering a more progressive system will benefit women, as will the expenditure side when we come to that, whether that is for childcare, education or other specific entitlements. Because of the composition of the workforce and also because of pay policy, lower-paid beneficiaries will include women. In making sure that we have aligned our pay policy and tax policy, as well as our overall expenditure plans, equality has been in the forefront of our minds.

The Convener: Do you have any other questions?

Emma Harper: No. I am quite happy about the benefits, because of the feedback that I have had from people.

Patrick Harvie: I will pick up on the anomaly that other members have asked about. Derek Mackay has described it as an unfortunate but inevitable consequence of what he is doing. It is not inevitable. He has described the change as a great restructuring, which I very much welcome—I have argued for restructuring of income tax bands for some years. However, if we are to restructure income tax, it seems to me that that would be an ideal opportunity to set the bands and thresholds as we think they ought to be, rather than to base them on an inflation calculation that has been derived from the old abandoned structure. Why are you doing it that way?

Derek Mackay: I think that I have tried to cover those points, and at no point have I said that there is not a choice. I said that where we set the thresholds is a choice for Parliament. It is just normal that thresholds increase in line with inflation, but there is a choice. It is also true to say that, in restructuring, our competences allow us to set the bands, rates and thresholds where we want them to be.

To take a two-year view, those who did not benefit last year will be beneficiaries this year of the structural change. However, Parliament can choose to do otherwise. I have tried to describe how we have arrived at the structure. I could say more, but it is basically about increasing the higher-rate threshold, which we did not do last year. As Patrick Harvie well knows, that was necessary in order for the budget to be supported. That is just a fact of the engagement on the budget last year.

Patrick Harvie: If it is "normal" to increase thresholds by inflation, I will ask a question that you did not properly answer last year. Why do you not want to increase the top-rate threshold by inflation?

Derek Mackay: That is because we have looked at the structure and the tax base and have engaged with a number of stakeholders about what the tax system should look like, and the structure right now is where we think that it should be. From memory, it means that about 19,000 people are in the band for the top rate of tax. Of course, we have—

Patrick Harvie: Forgive me. You say that you have consulted people about that, but all the approaches that are outlined in your discussion paper on the role of tax in the Scottish budget are based on a higher-rate threshold that is an inflation-based increase from where it currently is, and a top-rate threshold that is precisely where it currently is. You therefore have not actually consulted people or asked them about what the options might be. Every single option that you have put forward was based on the assumption that you are going to increase the higher-rate threshold by inflation.

Derek Mackay: I assure Mr Harvie that having invited the political parties to make submissions about the tax discussion paper, they could send me submissions on any composition that they liked. In my request for submissions, I asked specifically for views on thresholds and inflationary assumptions—

Patrick Harvie: The approaches in the discussion paper are not from other parties; they are your approaches.

Derek Mackay: I was about to come to that. I am just making the point that I responded to the political parties about their submissions in that exercise. In the subsequent engagement that I had, people were perfectly free to make suggestions that went beyond illustrative modelling—they were perfectly free to make alternative suggestions. I have to say that, in all the engagement that I had, I was not pushed on and did not get a lot of questions about the thresholds for the top rate of tax—the additional rate. There were, in fact, more questions around the rates or the assumptions that people had made. However, I had an open mind about people engaging on other matters.

I think that the balance that we have struck is the right one, however. In terms of the composition of the tax base, we have understood as best we can the behavioural effects and have arrived at a system that will generate the right amount of income and revenue. There is obviously a specific argument about the top rate, but we have tried to ensure that we will raise the optimum amount of money for next year.

Patrick Harvie: I make it clear, just as I did last year, that I am suggesting not that we should increase the threshold for the top rate but that there is an anomaly and that the fact that you are not doing that challenges your claim that it is "normal" to increase thresholds. You have produced a set of proposals that are based on an assumption that high earners and higher-rate taxpayers ought to get the benefit of a threshold increase. What alternatives or variations did you consider in developing that discussion paper or, subsequent to that, in the development of your draft budget? What other options did you examine, cost out and then rule out of consideration for publication alongside the draft budget?

Derek Mackay: To go back to the top rate of tax, I say that we have not increased the threshold for that rate. There is an argument for moving it, but it has remained static. I make it clear that my point was more about other rates.

Obviously, during development of the discussion paper on the role of income tax that led to the draft budget, I looked at different scenarios involving what different numbers would mean and what the outcomes would be. The reason why is that, following the Chancellor of the Exchequer's budget, I had a different set of numbers to work with. The position was fluid and yet to be determined.

I looked at various modelling and different tax policies. In real time, the civil service was trying to get a better understanding of the Fiscal Commission's modelling, so that the civil service could get as close to SFC modelling as possible in order to understand whether what we propose will have the outcome that the SFC says it will have, because that is then what I have to put in the budget. That was a pretty intense period of exploring the numbers and the fluidity of the numbers in order to arrive at the final proposition that I gave to the SFC, which it put in a document. Of course, that informed the draft budget. The position was pretty fluid during that period.

Patrick Harvie: I will ask about two specifics and whether they were considered. The proposal in the draft budget is closest to approach 4 in the discussion paper, that being the only one that has 19p, 20p and 21p rates. The main difference is the absence of an additional band between £75,000 and £150,000—the top end of that higher-rate range, which you have not included in your proposals. Was that considered and, if so, why was it ruled out?

Secondly, did you consider a different threshold for the intermediate rate? It would be possible, for example, to set a higher threshold for that, but to levy it at a higher rate, thereby protecting people on middle incomes and even people on slightly above the middle income, while having a more progressive approach overall.

Did you consider those two specific alternatives and, if so, why did you rule them out?

Derek Mackay: I would need to revisit the working notes that I made at the time. I have tried to describe fairly to Mr Harvie what was a pretty fluid situation. Our decision was not driven just by what looks like the perfect structure; it was also driven by needs in terms of public sector investment, the different factors, and the methodology from the SFC. There was a range of factors to consider.

As I said, there was an intense period after the UK budget of getting the settlement numbers, understanding how the SFC was arriving at its modelling, and assessing what expenditure demands would be. All that was fluid. At the same time, we were trying to ensure that the system, the structure and the thresholds were where we wanted them to be.

We received a variety of submissions from other political parties and there were a variety of considerations to take into account. It is true to say that the outcome is a hybrid of the illustrative approaches that were set out in the discussion paper on tax in terms of suggesting the introduction of a starter rate as well as increasing the number of bands overall. As I said, it was a fluid situation.

I applied the four tests and we looked at the numbers and we understood the modelling, and the outcome is what I have proposed in the draft budget.

Patrick Harvie: I want to ask about reconciliation, as well.

The Convener: I will come back to you later. Ash Denham wants to cover issues about pay policy.

Ash Denham (Edinburgh Eastern) (SNP): Recently, there has been a change in the public sector pay policy with the lifting of the 1 per cent pay cap. If that goes ahead, it will result in pay rises across the public sector. What are the implications of that policy in terms of revenue raising?

Derek Mackay: I believe that the SFC built into its forecasts the proposed pay policy figures, which will generate a sum of about £55 million for income tax.

The Convener: Neil Bibby has a question on local government and council tax.

Neil Bibby (West Scotland) (Lab): Earlier, you said that Scotland is not just the most fairly taxed part of the UK but, for the majority of taxpayers, the lowest taxed part of the UK. In your budget statement you said that your decisions would

“safeguard those on low incomes”.—[*Official Report*, 14 December 2017; c 56.]

Have you taken into account the impact of a 3 per cent rise in council tax across the board when making those statements, particularly the impact on those on low incomes?

11:45

Derek Mackay: Yes. At the moment, it remains the case that council tax is still lower on average than it is south of the border. That is even with the changes to the higher value properties last year. I am convinced that, if a council chooses to use its power to raise the council tax by up to 3 per cent, it should not have a disproportionate effect on household budgets. The council tax freeze was necessary at the time, but local authorities should now have the discretion to increase council tax.

On settlement issues, the 3 per cent is proportionate. Many people, including Neil Bibby, have argued in the past that councils should have discretion to increase the council tax. It is now for them to determine whether they use that discretion. Of course, as part of council tax, there is council tax benefit, which safeguards low-income earners, single people, pensioners and others.

Neil Bibby: Do you not accept that the reduction in tax liabilities for people on low incomes, which might be only £10 or £20 excluding the changes to the personal allowance, could be more than wiped out by a 3 per cent increase in council tax and that the end result of your decisions could be that those on low incomes pay more tax when council tax is included?

Derek Mackay: Council tax is not the decision of the Scottish Government; it is a decision of local authorities. As Mr Bibby would expect, I argue that local government got a fair settlement from the Scottish Government. Whether councils choose to increase the council tax is up to them, in dialogue with their local communities.

Neil Bibby: I understand that it is a decision for councils to make, but we need to consider the overall tax take from people on low incomes in the round. I encourage you to examine the impact.

Derek Mackay: That is a very fair point. Of course I should consider taxation in the round in arriving at my decisions. There has been substantial engagement on and a substantial shift in income tax this year to restructure it and make it fairer and more progressive.

I look forward to seeing the Labour Party’s position on income tax, which I am told is imminent. It would have been helpful if it had come before the discussion paper, after the discussion paper or during the parliamentary discourse. Every other party seemed to want to engage in that discussion, but even after the Labour Party found a new leader, I still did not get a tax position. However, I am delighted to hear that I will know its income tax policy. Maybe the Labour Party should take into account its position on income tax when it derives one on council tax as well.

Neil Bibby: Thanks for that, cabinet secretary.

Derek Mackay: My pleasure.

Neil Bibby: You said that, if councils raise council tax by 3 per cent, it will give them £77 million extra revenue to spend. Next week, we will have a debate about the impact of that on spending. Why have you not provided that £77 million extra through income tax? Would it not be more progressive to raise it through your progressive income tax proposals than through council tax?

Derek Mackay: It is fair to say that the income tax policies that I propose are more progressive by their nature. Income tax was progressive, but the changes that we propose make it more progressive.

The Parliament voted to continue engagement on reforming council tax. I am happy to do that, but we need to go beyond just providing a critique of the Scottish Government and on to considering what alternatives might look like. The responsibility is on the Opposition to do that.

Yes, I happen to think that income tax is more progressive than council tax by virtue of the fact that it more accurately assesses income. Council tax is, of course, a property tax not an income tax, and therefore it assesses the value of property. There are safeguards and checks within it. However, with the substantial change to income tax to deliver a fairer society, we need a degree of stability right now, and, if we are to make any changes to the council tax system, we should engage constructively in that. That is the plea that I have made to all Opposition parties.

I have adequately supported local government. I set that out in the budget. I have engaged with local government. I have met a number of council leaders and the Convention of Scottish Local Authorities. I know as a matter of fact that the proposed settlement is far better than they anticipated. It delivers a small cash increase and, if councils use the council tax powers up to 3 per cent, a real-terms increase. That said, it is a matter of discretion for local government.

Maybe I should not get into the party politics, but it is strange that Labour members ask me about council tax increases when it was eight Labour authorities that did not increase the council tax and, at the same time, those members say that those local authorities do not have enough money. It is a strange argument to say that a council does not have enough money, therefore it proposes to raise less.

The Convener: Patrick Harvie has a question a slightly different issue from what we have been discussing: budget adjustments for the longer term.

Patrick Harvie: This is a longer-term question about the way in which the forecasts of revenue raised will be reconciled in the longer term. It is not specifically about just the 2018-19 budget, but is about how we will do budgets generally under the new arrangements. I preface the question with my usual apology for my share of culpability for the Smith commission and what it did.

The forecast of income tax revenues is unlikely to be absolutely spot on. To the extent that it is wrong, that will be reconciled in time for the 2021-22 budget. Is that correct?

Derek Mackay: Yes.

Patrick Harvie: One of the briefings that we have had suggests that it is not implausible that the difference could be in the order of hundreds of millions of pounds. Is it a realistic prospect that the difference that is adjusted might be in the order of hundreds of millions of pounds in any one year?

Derek Mackay: I do not want to cause alarm. It is plausible that that might be correct. It is not necessarily likely, but it is possible, for the very reasons that Patrick Harvie has given. They are only forecasts.

You are right—this is a product of the agreement, the system and the fiscal framework, which is based on forecasts and block grant adjustment. At the point of reconciliation, it may well be hundreds of millions of pounds, or it may not be, and it might be either way.

Would you like Simon Fuller to say more, as the economist who is charged with forecasting such matters?

Patrick Harvie: Sure.

Simon Fuller (Scottish Government): I would add only one other point. You are right: the Scottish income tax forecast may be wrong and it will need to be reconciled, but what is really important for our budget is the difference between that error and the error that the OBR is likely to make in forecasting block grant adjustment. It is the net effect of those two numbers that will be really key. We would expect that net effect to be slightly smaller, perhaps, than two individual effects. As you say, however, it does vary, and the forecasts will certainly be different.

Patrick Harvie: Given that that kind of variance is possible—I am not suggesting that it is likely—there needs to be some willingness to work with that possibility and take account of it. Does it not slightly undermine the argument that some have made that the purpose of tax devolution was to make a Scottish Government accountable for the tax decisions that it makes if the consequences of those decisions are only really felt towards the end of a session of Parliament when decisions were made at the start of it?

Derek Mackay: It is interesting that Patrick Harvie asks me about that. I was not a member of the Smith commission, but I am a beneficiary of its agreement and I am administering it as best I can as finance secretary—

Patrick Harvie: I ask myself questions about this all the time.

Derek Mackay: I support the devolution settlement, the fiscal framework and the fact that we have more powers. I think we can all agree that it is a pretty complex way to determine a budget, and the fact that the budget is underpinned by forecasts that are reconciled in a future year does bring those risks. It is a fair point and a fair analysis.

What behaviours does it generate? I think it will encourage us to ensure that we have future flexibility. Of course, there are mechanisms in place if there is a forecast error, such as the borrowing capacity and facility, if that is required. Many of us have said that the SFC's projections may be a wee bit cautious. It could be argued that that is a good thing in that regard.

It will come down to the reconciliation compared with the OBR's figures. Although we have that flexibility, with borrowing powers in the event of a major discrepancy, I think it should encourage any finance secretary to have some medium-term financial planning as well.

The committee has encouraged such planning, and I am keen to do even more than has been done in the past. As the functions of the Parliament have progressed and matured, we need to prepare for such scenarios. The current projections are good, but the point is fair. If we design a system based on forecasts, it will carry risk.

Patrick Harvie: What level of flexibility currently exists? The committee and the budget process review group have said that sometimes there has been a lack of transparency around mechanisms that give the Government flexibility year to year. Will you argue for any changes or additional forms of flexibility to mitigate the potential risk, whether the risk is in your own term in office or for the longer term?

Derek Mackay: That question relates back to the answer that I gave to Mr Tomkins about what is, in essence, a maximalist position on fiscal autonomy. The more control that we have, the better, to help us to address anomalies and have more flexibility and room for manoeuvre in the event of such a scenario as Mr Harvie has described. That said, the resource borrowing facility—what it looks like and what it could be—is a matter of public record.

On budget transparency enhancement, the budget document does not just set out what was traditionally set out, and that is partly because of the budget process review group. On page 184, I have set out other contributing factors to the budget, which is a new approach. I have tried to be more transparent about elements beyond just tax and spend, such as budget exchange. Those elements have sometimes been reported on outturn, but I have set them out at the start of the budget process, in table 1 on page 184. I have tried to improve transparency and to show how we are thinking ahead in the modelling.

The system is so complex that it carries risk. We have talked about a few million pounds in the block grant adjustments for some taxes, and those are just the forecasts. Members have already been fully briefed by the SFC and the OBR, and I am sure that you enjoyed the sessions on methodology and the factors that have built up their forecasts.

Of course, if you ask two economists for a view, you will get a range of different answers. I make the point that there is uncertainty. Each agency has provided its best estimate, but the SFC is different from EY and different from the Fraser of Allander institute. Risk is carried in how we conduct the budget process that has been derived from the fiscal framework, but, fundamentally, the way that the Parliament has exercised its new devolved functions has been well received. It has been the right thing to do and it has made us more accountable and made us more engaged as a nation. I hope that we can make the right policy interventions and that any risks can be mitigated.

I am sorry for going on at length on this question, convener. My final point is that reconciliation should not be a massive shift, with regard to the forecasts, the in-year assessments and the work of HMRC. The actual outturn should be more stable and certain than is currently envisaged, because we are using baseline data that is not yet concluded because it is from 2016-17 and people have not completed it. The issues are terribly complex—that is the best that I can do to explain. I appreciate the points that have been made.

The Convener: We will relieve Patrick Harvie from torturing himself about his time in the Smith commission and the impact that it has obviously had on him since.

Patrick Harvie: I have torn out all my hair.

The Convener: I thank the cabinet secretary for coming along to give his evidence today. We look forward to meeting him again in Aberdeen on Monday to discuss the expenditure side of the draft budget.

Meeting closed at 11:59.

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