OFFICIAL REPORT
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Finance and Constitution Committee

Wednesday 9 January 2019

Session 5

The Scottish Parliament
Pàrlamaid na h-Alba

Wednesday 9 January 2019

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FINANCE AND CONSTITUTION COMMITTEE

1st Meeting 2019, Session 5

CONVENER

*Bruce Crawford (Stirling) (SNP)

DEPUTY CONVENER

*Adam Tomkins (Glasgow) (Con)

COMMITTEE MEMBERS

*Tom Arthur (Renfrewshire South) (SNP)
*Neil Bibby (West Scotland) (Lab)
*Alexander Burnett (Aberdeenshire West) (Con)
*Willie Coffey (Kilmarnock and Irvine Valley) (SNP)
*Angela Constance (Almond Valley) (SNP)
*Murdo Fraser (Mid Scotland and Fife) (Con)
*Emma Harper (South Scotland) (SNP)
*Patrick Harvie (Glasgow) (Green)
*James Kelly (Glasgow) (Lab)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Professor Francis Breedon (Scottish Fiscal Commission)
Robert Chote (Office for Budget Responsibility)
John Ireland (Scottish Fiscal Commission)
Dame Susan Rice (Scottish Fiscal Commission)
Professor Alasdair Smith (Scottish Fiscal Commission)
Professor David Ulph (Scottish Fiscal Commission)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Finance and Constitution Committee

Wednesday 9 January 2019

[The Convener opened the meeting at 09:31]

Decision on Taking Business in Private

The Convener (Bruce Crawford): Good morning and welcome to the first meeting in 2019 of the Finance and Constitution Committee. I wish a happy new year to all members of the committee, all panellists and everyone in the room. As I usually do, I remind everyone to put their mobile phones into a mode that will not disturb proceedings.

Agenda item 1 is a decision on taking business in private. Do members agree to consider a draft report on the Scottish Government's budget for 2019-20 in private at future meetings?

Members *indicated agreement.*

Budget Scrutiny 2019-20

09:31

The Convener: Under agenda item 2, we will take evidence on the Scottish Government's budget for 2019-20 from the Scottish Fiscal Commission and then from the Office for Budget Responsibility. For our first session, we are joined by Dame Susan Rice, the chair of the Scottish Fiscal Commission; John Ireland, the chief executive; and Professor Alasdair Smith, commissioner. We are also joined, for the first time as commissioners, by Professor Francis Breedon and Professor David Ulph. We look forward to working with you in your new roles, not only today but in the future. I welcome all the witnesses to the meeting.

I invite Dame Susan Rice to make an opening statement.

Dame Susan Rice (Scottish Fiscal Commission): Thank you very much, convener. You have just taken the first three sentences of my opening statement, which are to offer all of you good wishes for a healthy and prosperous new year and to introduce my colleagues. We are very pleased to be here. Thank you for having us.

This is the commission's third forecast report since we became a statutory body, and it is our second budget forecast. As before, we give an economic outlook for the next five years and we forecast devolved tax receipts and social security spending.

I want to mention a few areas in which we have added to or enhanced what we put in the report. We have expanded our focus on the fiscal consequences of our forecasts and on the block grant adjustments as the fiscal framework matures and we start to get a better sense of the likely scale of reconciliations, particularly for income tax.

The economic outlook for Scotland over 2018-19 has improved since our previous forecast in May. The latest forecast reflects several things: recent stronger economic performance in Scotland; a more positive prospect for earnings over the next couple of years; and the increased public spending that was announced in the United Kingdom autumn budget. We forecast that there will be stronger economic performance over the next two years but, after that, our outlook is more subdued, with annual economic growth expected to settle back to about 1 per cent again. As in our previous forecasts, that longer-term outlook reflects continued low productivity growth compared with trends before the 2008 financial crisis. We still anticipate that productivity will start to recover gently in the later years of our forecast.

Brexit was at the front of our minds as we did our work, as it has been throughout our various forecasts in the past. Our economy forecast was prepared on the central assumption that the UK's exit from the European Union will be relatively smooth, or "orderly", to use the technical term. The assumption encompasses a number of possible scenarios—there is not one orderly exit; it could happen in a number of ways. However, a no-deal Brexit is considered to be a downside risk to the forecast and it is not factored into it, although it is probably somewhat of an increasing risk.

Our formal judgment was based on what we knew up to late November, when our economy forecast closed. Since then, as we have had no clearer idea of what is actually going to happen, we have kept an orderly exit central to our forecast. That approach could reflect any of a range of scenarios and, even if there is a disorderly exit, specific detail around that would also need to be developed in order to forecast it. None of the changes will happen overnight. As it turns out, our approach mirrors the one that was taken by the OBR in its UK budget forecasts in the autumn, which were published shortly before ours. Although we came to the conclusions separately, there are advantages in preparing the UK and Scottish budget tax forecasts on the basis of a similar view of the UK-EU negotiations.

Our tax and social security forecasts now play a greater role in the budget arithmetic, as more taxes and benefits are devolved. In total, we are forecasting that £15.2 billion will be raised by devolved taxes in 2019-20, which is just over a third of the Government's budget. Our forecasts show how the Scottish Government's policy choices are affecting the Scottish budget. Income tax and land and buildings transaction tax are both raising additional revenue as a result of changes that were announced in the budget, while receipts from non-domestic rates will be lower.

Taxpayers inevitably respond to the incentives that are implicit in the tax system, and estimating the scale and impact of behavioural change is an important part of our work. In last year's forecasts, we included an adjustment for behavioural responses to the introduction of the new five-band income tax. In this forecast, we have looked at the behavioural response to the freezing of the higher-rate threshold. Although it is important to consider such effects, their magnitude is small. As a result of behavioural responses to the UK tax system, we have reduced our income tax forecasts by £13 million, which is about 0.1 per cent of the £11.7 billion that is forecast for income tax revenue.

Social security features again in our report, with new and expanded benefits in Scotland bringing total spending on social security to £458 million in 2019-20. As benefits have been devolved, the Government has introduced reforms by extending entitlements, making it easier to apply and increasing payment amounts. In 2019-20, we estimate that the new and expanded social security payments will cost £90 million more than the funding that is received from the UK Government for those particular programmes. In April 2020, the Scottish Government is due to take executive competency for the remaining benefits, which will be worth around £2.6 billion. Social security forecasting will become more important for the Scottish budget, as all those benefits have block grant adjustments and associated reconciliations.

Since we last gave evidence to the committee, we have continued to work on access to the data that we need for our work on social security. I am pleased to report that we have had a number of quite constructive conversations with the Department for Work and Pensions and have reached an agreement that will allow us separate and timely access to information that is already provided to the Scottish Government. We are still to finalise a memorandum of understanding, but the DWP is now taking our need for access to data seriously. I was pleased that, yesterday, Robert Chote and I signed a formal MOU between the commission and the OBR, reflecting the strong and collegiate working relationship that we have developed over the past several years.

Thank you for listening to my comments.

The Convener: Thank you, Dame Susan. In your introduction, you discussed behavioural responses and I want to begin this morning's discussion on that point. I need you to enable me, and perhaps some of my committee colleagues, to get a better understanding of the correlation between the commission's forecast of behavioural responses to the Scottish Government's tax policy changes and its forecast for the increase in the number of top-rate and higher-rate taxpayers.

I will give examples of what I mean. Inevitably, they include a lot of numbers, but I guess that that is part of the game that we are involved in this morning. In May, the commission forecast the number of additional-rate taxpayers to rise by 700 between 2016-17 and 2017-18, which was the year before the rate increased to 46p. However, between 2017-18 and 2018-19, which is the year in which the rate increased, the commission forecast that the number of top-rate taxpayers would increase by 900, and that it would increase by a further 900 in the year between 2018-19 and 2019-2020. We have seen another forecast increase of 1,200 between 2019-20 and 2020-21.

I need you to help me understand how you are able to forecast a larger increase in the number of top-rate taxpayers after the increase in the tax rate than before, given that you also forecast a behavioural response to the tax changes. There is something in there that I just do not get.

Dame Susan Rice: I will try to give you a one-sentence answer, and then I will turn to one of my colleagues to give you a little more of the detail. Like shifting sands, the numbers of people in each band will necessarily change over time, irrespective of the bands themselves. If the Scottish population grows, if people come into certain types of jobs and if earnings change, people will move category—that just happens. Those changes will therefore happen necessarily, and the specific numbers are part of the forecast judgment that we bring to the matter. David Ulph might want to—

The Convener: Before David comes in, let me pursue the point. If we put all the numbers together, we are talking about the number of our top-rate taxpayers rising—there will be 13,300 more of them—between 2016-17 and 2020-21. To me, that means that more is going on than just the sort of changes that you mentioned.

I will bring in David Ulph.

Professor David Ulph (Scottish Fiscal Commission): As Susan Rice said, there are two drivers, and one is the changes in the number of taxpayers who are eligible for those tax bands. For example, if some very high-income individuals were attracted back to Scotland through migration, they would go into the top tax band. An increase in the number of taxpayers comes about through a variety of forces, such as growth in population and migration. In addition, if employment increases, that will bring people in, although more at the bottom end of income distribution and in the bottom tax bands.

The major force that is driving up the number of taxpayers is the fact that earnings increase faster than the tax threshold. If earnings go up faster than the tax threshold, we are therefore sucking people from the lower tax band into the higher tax band. We have assumed that the threshold for the top rate of tax will be frozen at £150,000 throughout the five years of the forecast. Someone with earnings sitting at just below £150,000 who has, say, 2 or 3 per cent growth in their earnings will inevitably be pulled above that £150,000 threshold.

We have assumed that the higher-rate tax band will be frozen for 2019-20, but that it will be uprated in line with inflation in the remaining years of the forecast. However, given our forecast on earnings, it will still be the case that earnings will rise somewhat faster than inflation, so earnings will rise faster than the higher-rate threshold will increase in the later years of the forecast. Again, we have that force of pulling people with earnings just below the tax threshold into a higher tax band. There are quite powerful forces driving up the number of taxpayers, and they happen in any country with a progressive tax system. People are inevitably pulled up through the various tax bands as the economy grows and as their earnings grow.

There are two components to the behavioural effect that we are looking at from the decision to freeze the tax rate—to freeze the higher-rate threshold—while the UK Government has increased the threshold to £50,000. As you are interested in the number of taxpayers, I will focus first on what we call the external margin effect. People in Scotland who are above the higher-rate threshold will end up paying more tax than their equivalents in the rest of the UK. That will cause some taxpayers who are resident in England and who are considering whether they want to move to Scotland to decide not to move to Scotland. Equally, some taxpayers who are resident in Scotland could decide that they want to move to somewhere in the rest of the UK.

09:45

When people move from Scotland to the rest of the UK or do not move from the rest of the UK to Scotland, Scotland loses their entire tax revenue. Therefore, it is not necessary for very many people to decide to move from Scotland to the rest of the UK or to not move from the rest of the UK to Scotland to have quite a big impact on tax revenues. As Susan Rice said, we forecast that around £6 million of tax revenue will be lost because of those behavioural effects. That can come about through a relatively small number of taxpayers deciding to move south or not to move north. Both those effects are included.

The increase in the number of taxpayers is relevant only to the taxpayers who are in Scotland; it is only that effect that will be picked up when we look at the number of taxpayers. The fact that somebody chooses not to move to Scotland will not affect the number of taxpayers in Scotland, but it will affect the lost tax revenue. There are different impacts of those behavioural effects that will not necessarily affect the number of taxpayers.

The Convener: For me, the nub of the issue is how you are able to forecast a larger increase in the number of top-rate taxpayers after the increase in the tax rate compared with before it. I understand all the factors that you have described, but I do not get that bit.

Professor Francis Breedon (Scottish Fiscal Commission): A simple way to think of it is that, with a stronger earnings profile, the migration from one band to the other is stronger. In other words, the earnings profile necessarily generates a bigger transition into the higher-rate band.

The Convener: So it is just down to the level of earnings growth.

Professor Breedon: It not down solely to that, but that is one of the important effects.

Professor Ulph: It is simply the case that the numbers are different. A large number of people will be hauled above the threshold because of the increase in earnings. More people will be affected by that than will be affected by the behavioural changes. As I said, it is not necessary for very many people to choose to move south because of higher taxes in Scotland to have a big impact on tax revenues, because Scotland loses the entire tax revenue from those people.

The Convener: I have one more question to ask on this subject; I know that other members want to get in. The tax issue is one side of the equation, but in the analysis that you carried out, did you take into consideration the flipside? I am referring to issues such as free tuition and free care for the elderly. To what extent did you take account of that in your analysis?

Professor Ulph: The way in which the analysis is done takes into account the fact that we have people located on different sides of the border, some of whom will be very committed to being in the rest of the UK for family and employment reasons, who almost never move. Equally, there will be people in Scotland who have a great attachment to being in Scotland, and it would take an awful lot to get them to decide to move out of Scotland.

In between, there will be a number of people for whom there are pluses and minuses to being in Scotland or the rest of the UK—they see some attractions to being in Scotland and some attractions to being in the rest of the UK. Those are the people who are mobile. Relatively small changes in tax rates could cause those people to move from one side of the border to the other. The fact that they see some attractions to being in Scotland does not mean that they will not move, because they might see other attractions to being in the rest of the UK.

The Convener: Yes, but the bottom line is that your analysis was of the tax issue only; it did not look at the benefits that people get from being in Scotland, such as free tuition and free care for the elderly.

Professor Ulph: Those factors have not changed—we have had free tuition for years. Those factors will not affect people's decision about whether to move. The only thing that has changed is the tax change, so that is what we look at when we factor in the behavioural effects.

The Convener: Okay. I understand that.

Alexander Burnett (Aberdeenshire West) (Con): My question is a continuation of the convener's questioning. Despite the negative behavioural change, the number of additional-rate taxpayers will go up by 25 per cent, and the number of higher-rate tax payers will go up by 10 per cent by the next parliamentary session. You have said that that is not about migration in the rest of the United Kingdom and Scotland but about people moving from one band to another. With real earnings growth of 0.3 to 0.5 per cent over the two years before the next session, are you suggesting that 5,000 additional-rate taxpayers are sitting just below that band and are going to move up into it? How confident are you that you can see those people just below that band? The survey of personal income samples only 1.5 per cent of taxpayers across the UK, and the data is aggregated for Scotland, so how can you predict the volume of people who will flip if the earnings predictions are correct?

John Ireland (Scottish Fiscal Commission): You have hit the nail on the head pretty accurately. The survey of personal income gives us a distribution and shows who belongs to which band and where in the band they are. However, because it is a sample survey and because of the composite records for the additional rate it is not perfect. Given the information that we have at the moment from the survey of personal income, that is as well as we can do.

When we have the outturn data, that will make things a little bit easier, as we will have more information. At the moment, we have to make the judgments around where people are in the bands and how likely they are to move up when their nominal earnings increase on the basis of the information that the survey of personal incomes gives us.

The Convener: Adam Tomkins has a supplementary question on that very point.

Adam Tomkins (Glasgow) (Con): I am trying to understand how robust those numbers are. We are all learning about the art of economic forecasting—what is robust and reliable and what might be nearer the guess end of the spectrum. Where do those figures fit on that spectrum?

In your most recent forecast, you said that the number of additional-rate taxpayers in Scotland will increase by about 30 per cent during the years between 2019 and 2023 from 15,800 to 20,100. That is a significant jump, and it has massive consequences for the tax revenues that the Scottish Government receives because of the way in which income is prioritised in the basket of devolved taxation. How robust is that forecast increase of 30 per cent in the number of additional-rate taxpayers during that four-year period? Do you know that there are that many people earning £142,000 and that, in a few years, they will be earning £150,000 plus, or—I am not being disrespectful—is that forecast nearer to the guess end of the spectrum of forecasts that you are required to make?

Professor Ulph: Of all the types of numbers that we have been talking about, that one is relatively robust. We have a fairly good idea of the distribution of income among taxpayers in Scotland through the survey of personal income, and we can use that to fairly reliably project the shape of that distribution. The thing is that quite a lot of people are sitting just below some of those thresholds.

Adam Tomkins: We know that, do we? We know for a fact that quite a lot of people in Scotland are currently earning £140,000 or £145,000, and you predict that, within the space of four years, they will be earning £150,000 plus. You know that.

Professor Ulph: It is not a guess. We have a pretty good idea of the shape of the distribution of income in Scotland.

Professor Alasdair Smith (Scottish Fiscal Commission): I can be a little more specific. We know that income distribution at the upper end characteristically has a predictable shape that tails off quite sharply. As you move up the income distribution, you see fewer people. You have a relatively small number of people in the tail above the threshold compared with the number of people who are clustered just below it. Therefore, when the threshold does not move with inflation, you do—as your question implies, Mr Tomkins—get a surprisingly large number of people moving into the upper tax band. That is just a feature of the tail shape of the distribution, whereby quite a lot of people are closer to the border and a relatively thin spread of people are above the threshold—but it is a pretty robust feature of income distributions.

Adam Tomkins: You are not surprised by that surprisingly large number.

Professor Ulph: No.

Dame Susan Rice: No.

Adam Tomkins: Okay. Thank you.

The Convener: You will also not be surprised that we are asking the question.

Dame Susan Rice: No.

Patrick Harvie (Glasgow) (Green): I will pick up on some of Bruce Crawford's questions about the balance between the push and pull factors when comparing changes in income tax.

The convener mentioned some factors that Professor Ulph said have not changed, such as the social benefits of living in Scotland. However, there are other factors that will change, such as the affordability of housing, and some parts of the UK face a much more severe housing crisis than Scotland faces, albeit that there are challenges here. Furthermore, the decisions that people make—the behavioural changes that might arise—are not just a response directed at changes in, for example, tax policy, but a response to what people know, think and feel about those things. If the Fiscal Commission is not in a position to gauge a net effect, is anybody able to produce an overall sense of how the push and pull factors might interact or cancel each other out?

Professor Ulph: I have described a situation in which people who are on either side of a border feel some attachment to both areas. For those people, relatively small changes can cause them to shift from one area to the other. You are absolutely right in saying that, in that scenario, a whole variety of factors including family factors, employment factors and schooling issues can go into those decisions.

Patrick Harvie: It could be social, cultural or political factors—

Professor Ulph: Yes, social and cultural factors—all those kinds of things.

Patrick Harvie: It could be how welcome migrants feel in a political environment.

Professor Ulph: There are many places throughout the world where that situation arises. Think of the various states in America that have the same language and currency but have differences in schooling and other things. The position is similar in Australia and Germany. Lots of studies have been made of migration between the different states.

Each year, about 30,000 to 40,000 people move in both directions across the border between Scotland and England because new opportunities are arising and new factors are shifting and changing that are causing people to make those moves. Such moves across borders happen throughout the world. You can use evidence about whether those flows will be affected by tax differences to gauge the extent to which a small change in tax would induce a larger flow of people across borders. We use information such as that in our forecasts.

We use a lot of studies in many other areas, which gives us some confidence that we have well-established estimates of the percentage change in the amount of taxable income that we get in Scotland from a given percentage difference in tax breaks between Scotland and England.

Patrick Harvie: I appreciate that, but I am still slightly at a loss as to whether it is possible to do that work and then make a comparison using the other factors that might cause people to move, such as changes in housing affordability.

Professor Ulph: If there were studies that looked specifically at housing affordability, we could draw on them to look at the effects. However, we are focusing only on the effects of tax changes. Those effects have been well studied, so there are lots of studies on which we can draw.

Patrick Harvie: Last year, when the Fiscal Commission gave evidence at about the same point in the budget process, I asked about location issues—people's reported location for tax purposes, where they had moved to or from and whether they might change their decisions in the future. I was told:

> "We are not making a specific forecast on relocation; we are making an overall assessment of the impact. We are not setting out particular numbers for the impact of relocation or any other effect."—[*Official Report, Finance and Constitution Committee*, 20 December 2017; c 6.]

This year, there is a table—table 3.12—that sets out numbers for 2019-20 up to 2023-24, suggesting the impact on tax liabilities of immediate tax residency changes and the longer-term effects of migration to and from Scotland. Although you acknowledge that, in the most recent year on which you report, 2016-17, more people are moving to Scotland than are moving from Scotland, you are now at a point where you are putting specific numbers to some of the questions that, last year, you were not putting specific numbers to. How have you gone about changing that methodology, and what exactly has changed?

10:00

Professor Breedon: The methodology is simple. It is a question of how big the effect is. As you can see from the table, the effect is really quite small, but it is now big enough to be worth doing the work on. As the differences in taxes have got bigger, that has become a more material factor for us to think about. That is the process element of it; the technical element is a different issue.

Professor Smith: Last year, we were looking at a different central question about an increase of 1 percentage point in the higher rate, which is a relatively small increase spread across people. Here, we are looking at a different question: the effect of the difference between the Scottish higher-rate taxes, including national insurance contributions, and the UK rate. This year, we made a judgment that we particularly needed to look in more detail at the behavioural effects of that difference.

Professor Ulph: We have used some of the elasticities that I talked about, whereby we can say that a given percentage tax difference between two countries will cause a given percentage change in the taxable income in those countries. We have tried to help you by translating that into what that would mean for the number of taxpayers.

There are some other assumptions in there, as we have to make some assumptions about the average earnings of the people in those groups. However, one feature that you will see in table 3.12 is that the response in terms of tax residency is much stronger than the effects on migration. We made the assumption that people can shift tax residency quite easily, so we have assumed that there would be a higher response rate on tax residency than on migration. Migration is a much bigger decision—people have to choose to buy a house and move their whole family to a different region.

We have used a lot of different elasticities—which come out of studies that we have looked at—to underpin those numbers.

Patrick Harvie: I have a final question. Some of last year's discussion was about the fact that comparisons can be made with tax differences between US states, but there are big differences there in the context and the geographical scale. Is it possible for you to give us—perhaps in writing at another time—an overview of the specific jurisdictions that you have studied? There is evidence from other European countries that there is much less mobility among people at the higher end of the income scale, because they are much more physically invested in the place where they live.

Dame Susan Rice: We can follow up that question in writing.

Professor Breedon: There is one good study on the system in Spain, where they have that situation across the regions. One of the strongest studies that we looked at was on the Spanish system.

The Convener: You can get back to the committee on that.

Patrick Harvie: On an on-going basis, it would be useful to know what other places you are looking at, as we look at that year by year.

The Convener: Tom Arthur has a supplementary question on behavioural changes.

Tom Arthur (Renfrewshire South) (SNP): The question is on the increase in the number of higher and additional-rate taxpayers—it is supplementary to the earlier question.

The Convener: It is still related to the behavioural issue that I started off with.

Tom Arthur: Thank you, convener. It is a brief question for Professor Ulph, who has described one of the drivers of the forecast increase in the number of higher and additional-rate taxpayers in Scotland as being that those higher and additional-rate taxpayers would potentially relocate to Scotland. Would they be working in other parts of the UK but be resident in Scotland for tax purposes? Would they be setting up businesses in Scotland or relocating businesses to Scotland, which would drive that increase, or are there currently vacancies in high-salary jobs? Do we need people from other parts of the UK and elsewhere to come and fill those vacancies and, as a consequence, be registered Scottish taxpayers? Will that lead to the increase that you have described?

Professor Ulph: It will be a mixture of all those factors. People will see new opportunities arising in one country that will make them want to move from another country. People doing a job in England could be given the opportunity to do the same job at a higher salary in Scotland. A consultant working in the national health service in England might get a promotion to a higher-paid job in Scotland. People might move for those reasons. There might be people who are working on both sides of the border—sometimes in London and sometimes in Scotland—and they could just change their residency status.

Tom Arthur: I am keen to understand the balance between the creation of new higher-paid jobs within Scotland, which theoretically could be filled by anyone, including people currently resident in Scotland, and particular jobs elsewhere in the UK that would be performed by people who are resident in Scotland. For example, someone working in financial services could live in Edinburgh and commute to London. They would be a registered Scottish taxpayer, hence the revenue would accrue to Scotland rather than to the Treasury.

Dame Susan Rice: Right now, we have a fairly tight labour market in Scotland. It is not that there may be new jobs or new businesses; we are not looking at this tax from that perspective. However, as there are opportunities and openings, a Scottish organisation will need to pay to attract the right people. That will have an impact as well, but we are not starting out by asking how many new companies we expect to start and how many jobs that will create.

Tom Arthur: I understand that inward migration is essential for driving the increase in the number of higher and additional-rate taxpayers—

Dame Susan Rice: It is about earnings growth as well.

Professor Ulph: The increase in the number of higher-rate taxpayers is driven partly by increases in the number of taxpayers, but the largest driver is that, where earnings increase, existing taxpayers in Scotland move into the top-rate band. That is by far and away the most important driver, because, as Susan Rice says, we have a tight labour market and the population is not projected to grow very much, so the growth in the number of taxpayers is a relatively small factor. The big driver is the increase in earnings and the fact that the top-rate threshold is frozen.

Tom Arthur: I appreciate that. Thank you for that clarification.

The Convener: We will move on to more general earnings issues.

James Kelly (Glasgow) (Lab): I am interested in how pay and employment rates contribute to the overall tax position. Compared with the budget that was agreed in February 2018, the forecast position for 2019-20 has deteriorated by £963 million and the economic aspect of that is a £183 million decline. That is underpinned in terms of pay and employment. Compared with what you told us about in December 2017, there has been a slight decline in pay and employment rates. I am interested in how that has been built up.

Professor Breedon: The earnings picture has improved somewhat since our previous forecast. That picture is based on the past few quarters of data, which have given us a stronger earnings picture. I am not quite sure which comparison you are making—

James Kelly: I am asking specifically about the comparison with last December. The position has declined since December 2017.

Professor Breedon: Yes. In the previous forecast, we took the figure down but brought it back up again, though not as far as we did in December. That is just an issue of earnings outturns, which have been very weak in the past few quarters compared to prior to our previous forecasts, though they have got slightly stronger. It is just a response to outturn data—which, admittedly, for Scotland comes from a hotchpotch of different measures. The consensus of those measures is that the position has improved slightly in the past few months but is worse than it was prior to our previous forecasts.

James Kelly: The OBR is forecasting stronger earnings and employment growth. I am not asking you to comment on those forecasts, but why do we have a picture of declining earnings growth and a declining employment rate in Scotland?

Professor Breedon: The differences are quite small.

James Kelly: Yes, but that is the overall trend.

Professor Breedon: The key point is that the Scotland-specific numbers point to a slightly different picture from the UK-wide numbers, which is where this is coming from.

James Kelly: I am interested in understanding what the drivers for those numbers are.

Professor Breedon: That is a more difficult question. Over the past few years, productivity performance has been somewhat worse in Scotland than in the rest of the UK, which is probably an underlying driver. It is hard to translate directly, but there should be a link there.

James Kelly: You are saying that productivity is weaker here. What is causing that?

Professor Breedon: That is a very big question. We are struggling to work out why productivity performance is weak across all countries in the world. Productivity performance in Scotland in the past few years has been marginally worse than in the rest of the UK, but I do not know why that is, because we do not really know what the drivers are for productivity being so weak over the past 10 years across all countries.

James Kelly: Going back to the pay issue, I note that you comment in your report that the average number of hours worked has fallen in recent years but you see that number being static in the years ahead. What is the basis for that comment?

Professor Breedon: Sorry—could you repeat the question?

James Kelly: In a discussion on pay and productivity in your report that was published in December, you comment that the average number of hours worked per household has been declining in recent years but that, looking ahead, that number will become more static. What is the evidence base for that?

Professor Breedon: As we have mentioned, the labour market is tighter. One way in which that tightness shows itself is in the number of working hours going up as there is more overtime, people are asked to work more hours and, in general, there is less slack in the economy. That is one of the drivers for the number of working hours not having declined much.

Dame Susan Rice: I am not absolutely certain, but one factor might be that the shape of our population is a little different from that of the whole of the UK. We have an increasing proportion of people in the highest age groups, who are not necessarily as active in employment as those in the middle age groups. That creates some of the same effect, because, as the services of the people who are employed and working are needed, they might be offered—and take—more hours.

The Convener: I want to return to something interesting that Professor Breedon said. On the Scottish-specific numbers, you used the word “hotchpotch” about the numbers that are available. That suggests that the numbers that we can work with are perhaps not as robust as they could be. Is that because they are an extrapolation of UK-wide numbers? In that case, what could we do to improve it?

Professor Breedon: I might have slightly exaggerated; my key point was that there is more than one measure. When we look at the earnings profile in Scotland, we draw on about four different sources. I cannot necessarily comment on whether that data is stronger than the UK equivalent. However, it is the case that when we make the judgment on earnings, we are making it not on the basis of one earning series, but from looking at a range of series, which you can see in the report.

John Ireland: If you look at table 2.7 on page 64 of the main report, you can see that we have summarised the sources of earnings that are available to us. You can start to see the picture of stronger earnings growth in 2018, which is reflected in our report.

10:15

The Convener: I can see that. Are the data sources that are mentioned in your table sub-samples from the UK, or are they Scottish-specific samples?

John Ireland: The bulk of them are Scottish parts of UK surveys. Some of them are boosted in Scotland, proportionate to the population size. The final one—from the quarterly national accounts Scotland—comes from the national accounts, so it is slightly different.

The Convener: That must make your job more difficult in that area.

John Ireland: A characteristic of working with regional economies is that the data is not as good as it is for the national economy. However, as we said in September in our statement of data needs, a lot of advances are being made in Scottish data. Scotland is pretty well served by its economic data. There are gaps, which we have identified, but the picture is not as bad as it could be elsewhere.

Adam Tomkins: I am still struggling to reconcile all the various figures on forecast income tax receipts and forecast income tax payers. I am focusing on additional-rate taxpayers, because they contribute so much income tax, and income tax is so important to the devolved basket of taxation. We know that the top 1 per cent of income tax payers in the UK contribute more than 28 per cent of total income tax receipts, which is why maintaining and attracting ever-higher numbers of additional-rate taxpayers is critical to the future prosperity of the Scottish Government's spending plans.

The commission's forecast increase in the number of additional-rate taxpayers is—to use Professor Smith's phrase—surprisingly large. It is good to know that you are not surprised by that surprise, but that is a very significant increase. Over the period of only four years, we are talking about the number of additional-rate taxpayers going up by more than a third. However, over the same period, you forecast that income tax receipts will go up much more modestly than that. You forecast that income tax receipts will go up, but from £11.5 billion in 2019-20 to only just over £13 billion in 2022-23. Given that we know that additional-rate taxpayers contribute so much to overall income tax receipts, what accounts for the variation between, on the one hand, the number of additional-rate taxpayers going up very significantly and, on the other hand, the forecast Scottish income tax receipts going up relatively modestly? It is not behavioural change, because behavioural change accounts for only £6 million.

Professor Smith: No, but it is important, when thinking about the arithmetic, to remember that we are talking about the additional tax burden mainly being on people who, because of their income growth, move from one taxpayer category to another. It might be the case that additional-rate taxpayers as a whole pay a higher proportion of income tax revenue, but in the category of individuals who move, such individuals move from just below the tax threshold to just above the tax threshold. Their marginal rate might go up very significantly, but the actual tax bill that is paid by someone who moves from just below the threshold to just above the threshold changes relatively little. The changes to the number of taxpayers are driven by people who are close to the threshold and move over it, whereas the tax revenue figures are driven by the average tax that is paid by different taxpayer categories. The average tax that is paid by people who move just over the threshold does not change that much.

Neil Bibby (West Scotland) (Lab): I will follow on from Adam Tomkins's questions. At our last meeting, David Phillips from the Institute for Fiscal Studies warned that there was a big risk if Scottish revenues were overestimated and the OBR underestimated UK revenues. Do you agree with that analysis? What is the likely risk of that happening over the next two to three budgets?

John Ireland: I think that that observation was in relation to how forecast differences could drive the reconciliations arithmetic in a particularly bad way for the Scottish budget. David Phillips was just highlighting the circumstances in which that could happen. A table in the report looks at what we think is the current position on reconciliations and makes a forecast of that forecast difference. That shows that those adverse circumstances seem to be likely, but they can of course change; it is just a forecast of a forecast difference.

Tom Arthur: My question returns to the issue of data, and in particular data on average earnings. How much does the composition of earnings across Scotland inform your forecast on earnings? Particular areas historically have had a concentration of high earners—for example, the north-east because of the oil and gas sector and Edinburgh because of the financial services sector—which means that, to an extent, those earnings will inflate average earnings. However, those high-earning sectors might be more exposed than others to effects such as economic shocks. How do you come to your forecasts on average earnings? What data sources are available to you? Do they take account of regional variations involving clusters of higher earners in different parts of Scotland?

Professor Breedon: Our approach is very much at the aggregate level, so we do not get into those regional issues that much when we do our analyses. The regional effects that you referred to are fine for our purposes; they just mean that earnings could be more volatile. However, our focus is always on the Scotland-wide implications of changes.

John Ireland: It is also fair to say that when we think about the aggregate macro picture, we are thinking in particular about the onshore oil and gas industry, so we take that into account. We also take into account the prospect for the financial industries. Francis Breedon is right in saying that we think about those aspects at a very high aggregate level for Scotland, but we are not blind to the consequences for different sectors and how they will evolve over time.

Dame Susan Rice: I can give an example. When we looked last year at the land and buildings transaction tax, given the state of the oil and gas sector, we focused specifically on the north-east and did some work on what was happening in that area around housing prices and transactions, and so on. If we think that there really is something happening, we can go in and look more forensically.

Tom Arthur: In the comparison between the average earnings forecast for Scotland and that for the UK as a whole, I think that there is a difference of about 0.3 per cent in favour of the rest of the UK. Is that statistically significant?

Professor Breedon: Not really, no.

Tom Arthur: Thank you.

Angela Constance (Almond Valley) (SNP): Good morning, panel. Dame Susan, you said in your opening remarks that Brexit was at the front of your collective minds. Again, I note that in both your remarks and your report, you said that your forecasting is based on an "orderly Brexit". However, I think that the forecasts for an orderly Brexit are perhaps—if I can be kind—rather fluctuating. You also speak a fair bit in your report about the uncertainty around Brexit. Have you undertaken specific work on a range of scenarios, including a no-deal Brexit, and their impact on the tax take in Scotland?

Dame Susan Rice: We have discussed matters of that sort extensively. However, as I hinted in my opening comments, even if there is a no-deal Brexit or a disorderly exit from Europe, that does not have one shape. It is not as if there is just the Braeburn apple and that is it: apples come in a lot of varieties. If a no-deal Brexit is the outcome of the parliamentary vote, there will then be a period in which the detail around what that means and how it will operate will emerge. It would not make sense for us to try to imagine all that and do lots of different forecasts at this point. We need to wait and see what that detail is. We would then, at the right time—you must remember that we also forecast in relation to your timetable in the Parliament—produce a forecast for that. However, we are not sitting today forecasting every possible scenario, because we just do not have the details for that.

The fact that we do not have the detail is why we stayed with the notion of an orderly exit, which seemed the more likely prospect. At the moment, we have no detail that tells us that the UK's exit from the EU will be other than that—we can imagine that it might be, but we do not have the evidence for that. We need to wait for the evidence.

Angela Constance: I understand the difficulties with the lack of detail and the uncertainty that exists, and I would not expect any member of the panel to have a crystal ball. However, I notice that, in paragraph 29 of your forecast report, you tease out some of the underlying issues in and around Brexit. You say that the fact that productivity is predicted to be lower is

"in part due to Brexit."

You talk about international trade and the difficulty of predicting the future economic relationship between the UK and the EU.

You also talk about migration. I am particularly interested in the impact of Brexit on migration. There is fairly broad agreement on the fact that we face a demographic challenge in Scotland. We know that population growth is important to overall economic growth. The UK Government's white paper contains a proposal for a £30,000 minimum salary threshold for EU migrants. According to the Scottish Government, that would reduce migration from the EU by 80 per cent. We know that all our predicted population growth is based on migration. I know that you have not yet done work on this, but have you given some thought to how you will follow the impact of the reduction in migration on our tax take and our overall economic performance, which appears to be a live issue?

Dame Susan Rice: The three factors to which you referred do not relate to orderly or disorderly Brexit, or to no Brexit at all. We considered those factors as we thought about Brexit in our economic forecast last year. We discussed them in depth, and what our report says represents our judgment about the impact on migration post-Brexit. Alasdair Smith will give you some more detail.

Professor Smith: I emphasise that paragraph 29 of the summary of our forecast report refers to our existing forecast, which, as Susan Rice said, includes an assumption that there will be an orderly exit, in economic terms, of the UK from the EU at the end of 2020—at the end of the transition period. That assumption puts some downside forces into our forecast. As listed in paragraph 29, we assume that, in the central scenario of an orderly Brexit, there will be negative effects on migration, productivity and trade that will lead to income being lower than it would otherwise have been.

As Susan Rice said, we have not looked at what the effects would be if there were a disorderly Brexit, but from looking at the work that other people have done on a no-deal Brexit, we would expect all those negative effects to be bigger and there to be additional negative effects. There could be some quite big negative short-run adjustment effects at around the time of Brexit.

We have produced one forecast that is based on our central set of assumptions about Brexit and other matters—that is our job. If we proceed with an orderly Brexit, as we find out more about the way in which migration policy, for example, develops, that will be the time for us to feed more elaborate assumptions about migration into our forecast. You must be right that if Brexit—whatever form it takes—generates bigger reductions in migration than those that we have assumed in our current forecasts, that will have further negative effects on the economy.

10:30

One other matter to which I draw your attention is that we need to worry about the negative effects of migration not just because of the demographic effects that you have talked about, which are, of course, important—the 16 to 64 population in Scotland is a lower proportion of the overall population than in the rest of the UK—but because of the link between migration and productivity. The flow of migrants is not mainly into low-paid jobs; a lot of migrants come with high levels of education, skills and work commitment. There is no doubt that migration has a very positive effect on productivity. The expectation is that reductions in migration would have not just demographic effects, but negative effects on productivity.

We will need to explore those issues when we find out more about the Brexit path that we are currently embarked on, as it develops, or in relation to an alternative Brexit path, if that is where we end up. These are all very important things to which we will need to give careful consideration in the future, but we have not done that yet.

Angela Constance: I am interested in how quickly you will be able to do that once some light has been shed on the path that we are about to embark on, given that EU migrants are, indeed, net contributors. Furthermore, if the working age of the population is going up, they are presumably important in relation to tax take; there is also the important point about productivity. Whatever form Brexit takes, and given the UK Government's white paper on migration, you have talked about there being downside risks, whereas I would talk about that there being a devastating impact on our economy.

Bearing in mind our economic performance relative to that of the UK, all that has a big impact on how public services are funded in Scotland. How quickly will you be able to change your assumptions and do some forecasts that scope out the shape and size of the challenges that we are undoubtedly about to face?

Professor Smith: It is important to be realistic about the timescale. It does not take long to change assumptions, but changing the forecasts as a result of a change of assumptions is a process that takes time. We have a forecasting cycle. For our next set of forecasts, if we have a clearer picture of what Brexit means, that can be fed into the forecasting cycle.

There are limits to the extent to which the length of the forecasting cycle can change, not least because it will take time for us to understand what changes we need to look at in our next set of forecasts. We may get more clarity at some point about what form Brexit will take. If it were to be a no-deal Brexit, there probably would be significant macroeconomic changes at the UK level in response, and we would need clarity about those in order to produce our forecasts.

I do not think that one should imagine that our economic forecasts should be the front line of assessing the immediate effects of policy towards Brexit. For our next forecast, we will, to stick to your example, work through the effects of Brexit on productivity, if we see significant new effects coming along. I can imagine circumstances in which the timetable for our next forecast would change a bit, but we are not in the business of providing policy analysis for politicians making decisions about Brexit. You might wish that we were, but that is not what we do.

Dame Susan Rice: I will sum that up. Angela Constance started by asking how quickly we can consider things. We can move only as quickly as the detail emerges about Brexit, whatever form it takes. Therefore, we are restrained until some of that detail takes shape.

Angela Constance: I get the point that you have a specific job in relation to the Scottish budget, as opposed to the policy choices of Scottish politicians. However, the reality is that in your report you have started to scope out the impact of Brexit and your forecast will not be worth a jot if you do not do some sort of horizon scanning. Brexit is looming large, in some shape or form.

Dame Susan Rice: We will move as quickly as we are able to. There will be a tremendous change, whatever form Brexit takes, and we are well aware of that.

Emma Harper (South Scotland) (SNP): I want to pick up on what Angela Constance said. In Dumfries and Galloway, we have 48 per cent of Scotland's dairy farms. The big dairy farms employ Romanian, Lithuanian and Polish workers who are not making £30,000 a year. There is a mix. I know that the Scottish Dairy Hub is looking at exactly how many migrants are employed in the industry.

The devastating impact of Brexit on immigration that we are talking about will have a massive effect on productivity in Dumfries and Galloway and its contribution to Scotland's economy, if there is nobody to milk the cows. That is worth looking into. What are your thoughts?

Professor Smith: That is right: the agriculture sector is particularly vulnerable to the effects of Brexit on migration. It is probably one of the sectors that is most at risk from the effects of a no-deal Brexit, because if we leave the EU without a deal, it will be very difficult for British agriculture and fisheries to sell their products into the EU, which is a big part of their market.

There is no question but that, whatever form Brexit takes, it will provide big issues for the commission in our next cycle of forecasts.

Tom Arthur: I appreciate that much of Brexit can be only be termed “nebulous”. However, if the UK Government’s favoured policy is implemented—that is, the European Union (Withdrawal) Act 2018—the EU backstop scenario might emerge if the Irish protocol is invoked, and that would come into effect within the forecasting period that we are considering today, which reaches early into the next decade. The terms of that are well defined, including the regulatory divergence that would occur between Great Britain and Northern Ireland. Has there been consideration of that outcome to inform your forecast scenarios into the 2020s?

Professor Smith: The short answer is that we have not looked at such issues in any detail. It is a good example of why it would be premature for us to consider such an outcome, because no matter how carefully one reads the draft withdrawal agreement, it is simply not clear how much regulatory difference there will be between Northern Ireland and the rest of the UK in the backstop scenario. That is because, as I understand it, Northern Ireland will be obliged to follow EU rules on goods regulation.

The reality is that producers throughout the UK will have a very strong incentive to stick to the same rules. Companies that sell cars in Northern Ireland and supermarket chains that sell food products in Northern Ireland sell the same products there as they sell in the rest of the UK, and companies sell the same cars in Northern Ireland that they sell throughout the EU. Such UK producers will stick to EU regulation in any event. That is but one example of the kind of thing that needs to be thought through and understood—and not by us, in the first instance. We are not Brexit analysts; we are economic forecasters, but that is an example of the kind of complex issue whose effects we will need to understand much better as the situation evolves.

Tom Arthur: In the perhaps unlikely event that the withdrawal agreement is agreed to by the UK Parliament in the coming weeks, the Irish protocol being invoked is a concrete scenario that could emerge. If it does materialise, will the SFC consider its implications? It is a real scenario that is legally defined and will have to inform at least some of your forecasts and scenario planning.

Professor Smith: My initial thought is, frankly, that the scenario on which our forecast is based is the UK Government’s withdrawal agreement being passed by Parliament and the UK formally exiting the EU at the end of March and going into a transition period during which nothing will essentially change until the end of December 2020. I am not sure that we would feel under strong pressure to set about producing a new forecast other than on our planned timetable.

If the withdrawal agreement fails to get through Parliament and we have a disorderly Brexit at some point in the next two months, everyone who is involved in economic policy making and forecasting will need to think about what needs to be done and in what order. As I said earlier, we would need to think about how much clarity we would need on the policy responses to that scenario of the UK and the Scottish Governments before we could think about the implications for our next round of forecasting.

The Convener: That is helpful. You have made your position clear.

Murdo Fraser (Mid Scotland and Fife) (Con): I have questions about income tax forecasting, but before that, I have a follow-up question on what Professor Smith said a moment ago about migration, which I thought was interesting. You mentioned particularly the economic contribution that is made by migrants. Are you aware of any evidence that the economic contributions of migrants vary depending on whether they are from EU countries, non-EU countries or other parts of the UK?

Professor Smith: The short answer is no. A lot of work has been done on the positive effects of migration on economic performance, but I cannot—off the top of my head, and certainly not in terms of the report that is in front of me—point you to evidence of such differences.

Murdo Fraser: That might in the future be an interesting area to look at if, because there will be a reduction in EU migrants, there is an increase in the number of migrants from other parts of the world or other parts of the UK. An understanding of whether that will mean differences might be quite useful. That is not what I was going to ask about, but it is an interesting point.

I will ask about the SFC’s income tax forecasts. We see quite a substantial reduction in the forecast for income tax receipts from the forecast that you produced at this time last year. We have heard from you a narrative on why that is. To an extent, the reductions will be offset by changes to the block grant adjustment. What is of interest to the committee is the direct impact of all the changes on the Scottish Government’s budget for the coming year. What will be the net impact of the changes in what we expect in income tax for the coming year on the Scottish Government’s budget?

Professor Smith: That is set out in table 6, just below paragraph 41 of our summary. The top panel of that table shows our forecast for income tax for 2019-20, the forecast for the block grant adjustment, and the net difference of £182 million. That is the answer to your question. The table shows our forecast for the year 2019-20, and net receipts from income tax.

10:45

Murdo Fraser: I can see that. Thank you for your answer. Am I right in saying that this time last year the figure that you were forecasting was £591 million? We are talking about having roughly £400 million less than we thought then that we would have.

Professor Smith: Yes—but both our tax forecast and the UK tax forecasts, and the forecasts that underlie the block grant adjustment, have changed significantly, because in the intervening period we have had outturn data for 2016-17, which shifted both numbers down quite significantly. You are right to identify that the gap between them has also reduced, so we are now forecasting less net impact on the Scottish budget.

There are many moving parts that go into our tax forecast and the OBR's forecasts of UK taxes, which then feed into the block grant adjustment. An issue that is perhaps worth thinking about is that UK tax forecasts have been pushed up this year: unexpectedly strong performance of tax receipts in 2018 has led the OBR to increase its forecasts for UK income tax and other taxes.

We do not have as detailed information about Scottish tax receipts as the OBR has about UK tax receipts, because the range of data is smaller. However, in the information that we have, there is not evidence that Scottish income tax receipts have gone up as UK-wide tax receipts have gone up. That might be because there is a higher proportion of higher-rate taxpayers in the UK. There is some evidence—I am talking very cautiously, because in relation to both the UK and Scotland, we are talking about early evidence—that UK income tax receipts have gone up particularly at the higher end of the income distribution. There are proportionately fewer higher-rate taxpayers in the Scottish income tax distribution, so currently we think that Scottish tax receipts have probably not been subject to the same rate of increase in 2018 as UK tax receipts. That might be—I stress "might"—the reason why the difference between our income tax forecast and the block grant adjustment forecast has narrowed, so that the net impact on the Scottish Government's budget is now £183 million, rather than a larger number.

Murdo Fraser: Thank you. I think that I understand that.

Professor Smith: I appreciate that everything to do with the block grant adjustment is complicated: one has to work hard to keep one's thinking on the right lines. That's the way it is.

Murdo Fraser: Yes. The advice that we got from our budget adviser was that your most recent forecast implies a worsening of the net tax position, by £400 million, compared with your forecast this time last year. Is that correct?

Professor Smith: Yes, that is correct. If you look at table 8, entitled "Income tax reconciliations", you can see that for the 2018-19 budget, the net difference has changed from being plus £428 million to minus £43 million.

Murdo Fraser: That was helpful. Thank you for mentioning table 8, because I was going to ask about it next. The table shows, for last year, forecast reconciliation of £145 million, which will kick in in the year 2020-21, and for 2021-22 the forecast reconciliation is minus £472 million. I appreciate that those are only forecasts, but am I right in thinking that if your forecasts are correct, when the Scottish finance minister is setting the budget for 2021-22 he or she will be starting with a negative amount of £472 million?

Professor Smith: Yes. If our forecast turns out to be the case when we have the outturn data for 2018-19 in mid-2020 and the budget for 2020-21 is being set, there will be that negative number. You are right that it is a forecast of the extent to which a budget based on past forecasts will turn out not to be accurate. We should probably not get overexcited about the specific numbers. However, as I understand it, behind your question is the observation that the numbers are quite large relative to the budget, so reconciliations will be a very significant issue in Scottish budget management from next year onwards.

Murdo Fraser: Indeed. That was the point that I was going to come to. We are talking about half a billion pounds, which is a sizeable chunk of money to come out of a budget in what will be an election year. That could lead to an interesting political scenario.

What impact will the figure have on "the Scotland reserve". You talk in paragraphs 115 to 117 of your report about the amount of money in the Scotland reserve, and you observe in paragraph 116 that in terms of the budget for the coming financial year, the Scottish Government is proposing to

> "draw down £85 million from the capital reserve and £250 million from the resource reserve."

You also observe that that

> "is the maximum allowed within the fiscal framework."

Given that looming black hole, which might or might not materialise, how prudent will it be for the finance secretary to draw down the maximum from the reserve, when he should perhaps be filling it up?

Professor Smith: We have set out the facts as we see them as clearly as we can, because we think that the numbers are important. Judgments about the prudence of decisions are for the cabinet secretary and the committee, and not for the commission.

Murdo Fraser: Thank you.

The Convener: You will get a chance to ask the cabinet secretary that question next week.

Emma Harper: We have covered a lot this morning, and it has been interesting to hear some of the political and economic arguments for how income tax revenues are higher or lower in different areas. I am interested to hear what the main factors would be—economic or political—in determining whether the forecasts might be higher or lower for Scotland than for the rest of the UK. Your forecasts might not be accurate for some areas because of whatever happens with Brexit and wider issues.

Professor Breedon: The general point about forecasting is, sadly, that we have to do the best that we can with the information that we have today. Events are looming that will, almost inevitably, knock those numbers off track. I am afraid that it is the lot of the forecaster to see their forecasts going off track.

Emma Harper: Is Scotland at a higher risk than the rest of the UK in terms of some of the forecasting that you have engaged in?

Professor Breedon: No. The data that we start with is key to the forecasting process. I cannot think of a particular risk from what might happen in the next few years that would be worse for Scotland than it would be for the rest of the UK.

Dame Susan Rice: We lay out some different factors, but whether they will crystallise as a risk, or a downside risk, is another matter. However, as we said previously, we have a higher proportion of the population in the 64-plus age group and our population is not growing, particularly the working-age population, at quite the same rate as that of the rest of the UK. Therefore, some factors are different, including the tight labour market, which I mentioned. Those factors can have positive or negative impacts, but there are some core differences in our make-up.

The Convener: The final question on income tax is from Neil Bibby, then we will move to land and buildings transaction tax with Willie Coffey.

Neil Bibby: In table 3.7 of the report, income tax forecasts have been revised down by £275 million due to UK policy changes. Of that, £199 million is due to the increase in the personal allowance. Can you clarify which UK policies account for the remaining £76 million?

Dame Susan Rice: Which page is the table on?

Neil Bibby: I will find it.

John Ireland: It is page 92.

Dame Susan Rice: Okay.

John Ireland: I know that we have the answer to the question, but I cannot put my finger on it at the moment. Can we write to you with the answer? We have a detailed list, so that is probably the best way of handling that.

Neil Bibby: Okay.

The Convener: Willie Coffey has a question on LBTT.

Willie Coffey (Kilmarnock and Irvine Valley) (SNP): I bet that, at this stage of the meeting, the witnesses will be delighted to get a question on land and buildings transaction tax.

Dame Susan Rice: We would have been disappointed if we had not got one. [*Laughter*.]

Willie Coffey: The forecasts for LBTT revenue seem to be going up year on year, but we hear that growth in house prices is slower in Scotland. Why will we get more LBTT revenue over the coming years when growth in prices does not match it? The policy changes on the additional dwelling supplement would not account for the difference.

Dame Susan Rice: The simple answer is that it depends on where the transaction activity is greatest in the bands of LBTT. There being a lot of activity at lower bands will make a difference. Alasdair Smith is our resident expert on that.

Professor Smith: Although house price increases are lower than they have been at some points in the past, we still predict that house prices will go upwards. As Susan Rice said, the distribution of sales between bands changes over time. Having put all those things together, we forecast that LBTT revenue will rise over the years.

Willie Coffey: So, the rise is mainly because of thresholds and bandings and not the policy change on the additional dwelling supplement.

Dame Susan Rice: Yes—that is fair to say.

Professor Smith: Yes. The policy change is built into all the years of our forecast, so the rise over the years will be driven by house price rises.

Willie Coffey: Thank you very much. That was a nice simple question and a simple answer.

The Convener: That concludes the evidence session. We all know that the matter is complicated, so I thank the witnesses for bearing with us and helping us to understand it more clearly.

10:58

Meeting suspended.

11:09

On resuming—

The Convener: For our second budget scrutiny session, we are joined by Robert Chote, who is the chairman of the Office for Budget Responsibility. Robert has appeared before us on several previous occasions, and we are grateful to have him here again today.

Welcome to the meeting. You may make a short opening statement if you wish to do so.

Robert Chote (Office for Budget Responsibility): Thank you very much, convener. As always, it is a pleasure to be back. As Susan Rice's quintet has covered quite a lot of territory that I would normally force the committee to suffer through in an opening peroration, I will make just a couple of comments.

The last time we produced a forecast was in October, which now seems some distance back. Then, the big picture was that, despite the fact that the economy had not been performing very differently from how it was anticipated in previous forecasts that it would perform—the annual growth rate last year was fractionally lower, but that was largely down to the weather-based distortions earlier in the year—the fiscal outturn through 2018 was better than anticipated. That led to an improvement across the forecast, which was supplemented by our taking a slightly more positive view of prospects for employment growth over that period.

The underlying fiscal position had improved in that forecast by more than we would have expected simply from looking at the economic position. Indeed, it had improved sufficiently to the extent that, if the UK Government had sat on its hands in terms of policy, we would have been on course for the first time to deliver the balanced budget overall that is the Government's fiscal objective for the mid-2020s. As it happened, that windfall had, in effect, already been spent by the Prime Minister in the previous June, when she announced the additional money for the national health service. The other policy measures in the UK budget amounted to an additional giveaway in the near term that turned—in the typical Augustinian pattern—into a small net tightening towards the end of the forecast. Basically, the combination of the better news on the underlying forecast and the Government's fiscal giveaway left the path of borrowing in the medium term not very different from what it had been in the previous forecast.

As far as the timetable is concerned, the next forecast will be for the spring fiscal event. We do not yet know when that will be. The Government has asked us to be prepared for something on the normal timetable. We would normally be talking about the first couple of weeks of March, but we will see where we are. We will soon get under way with the first round of the economic and fiscal forecasts for that. We go through three iterations in the run-up to the point at which we close the forecast. After that, we allow only policy changes to affect it.

As Susan Rice mentioned in her evidence, to date we and the Scottish Fiscal Commission have based the forecasts on the assumption that there will be a relatively smooth, non-disorderly exit from the EU. We will have to keep under review whether that is still the appropriate horse to be sitting on as we go through the successive iterations of the forecast. As we get closer to the date, we will have choices to make about that. I suspect that Brexit will come up in questioning, so I will keep some of the content for that. I will leave things there, but I would be happy to expand on any of those issues.

The Convener: Thank you for those opening remarks—we are very grateful to you.

James Kelly: Good morning, Robert. I am interested in the earnings and employment forecasts. The SFC's forecast for Scotland shows weaker earnings growth and weaker employment rates compared with last year, whereas the OBR's forecast shows an improved position on earnings and employment rates relative to last year. I would not expect you to comment on the SFC's forecast. What were the drivers that led you to reach a more optimistic position?

Robert Chote: On the employment side, we reduced our estimate of the sustainable equilibrium level of unemployment from where it had been previously. We have done that in a number of recent forecasts. That is simply a reflection of the fact that, although unemployment has fallen—quite often, it has done so more rapidly than economists generally had anticipated—we have yet to see the substantive pick-up in inflationary pressure and wage pressure that we might have anticipated. On that basis, pushing down the sustainable level of unemployment that the forecast tends towards in the long term gives scope for greater employment growth over that period. That is the main reason.

11:15

In your question on earnings growth, you are obviously taking into account recent outturn data. As you discussed with the previous panel, there are different ways of measuring that. Earnings surveys look directly at the amount of income and divide by the number of people to see how earnings are moving, and we have new sources of real-time information from HM Revenue and Customs—at this stage, neither of us is placing huge weight on those, but they are additional sources of information. As Francis Breedon said, over the medium turn, the outlook for real earnings growth is driven by judgments on real productivity growth. As you know, the big picture is much weaker real productivity growth since the financial crisis and it is not surprising that that has corresponded with weaker earnings growth.

A couple of forecasts ago, we judged that productivity growth, and therefore earnings growth, would not get back to historically normal levels but fall some way between performance in recent years and performance over earlier decades. I suspect that the weaker outlook for earnings growth over the medium term in the SFC's forecast relative to ours is primarily down to it taking a slightly more pessimistic view of underlying productivity growth. Roughly speaking, for gross domestic product growth over the medium term, our overall numbers for the UK economy are about 1.5 per cent a year, and the SFC has the Scottish economy growing by about 1 per cent a year. The larger effect there is differences in population, but we would expect the difference that is accounted for by relative productivity to feed through to a difference in the earnings profile.

James Kelly: That is very helpful. Do you have any regional breakdown in your analysis?

Robert Chote: We do not, as we are primarily a UK-wide forecaster using an aggregate basis. For the production of Scotland-specific forecasts, the SFC takes a more bottom-up approach based on its analysis of Scottish economic determinants, whereas we look at what the Scottish share would be of the UK-wide picture and whether particular factors would move it around. One consistent reason to help to explain why the SFC's forecasts for Scottish income tax are somewhat weaker than ours is that difference, as the SFC is taking account of weaker expected earnings growth in Scotland.

James Kelly: I am also interested in your view on average hours worked, to give us some context. In the area that I represent, there are concerns that people sometimes have to do two or three jobs and work longer hours because wage levels are low. Looking ahead, do you see that in your forecasts?

Robert Chote: The data on that over the past few quarters has been quite volatile, so distilling a longer-term picture is difficult. Some way back, we assumed that average hours were generally on a long-standing downward trend, but, in the light of recent data, we might assume that the trend is flatter for the time being. We would be wary of looking too much at the quarter-on-quarter changes since the last forecast; we would have expected a bounce back from a number at the beginning of last year that looks erratic but has turned out to be more persistent and not the fall that we had anticipated.

Murdo Fraser: Good morning, Mr Chote. Looking at the overall economic and fiscal picture that you have painted, I note that you have said that the performance of the real economy has been less impressive relative to expectations. You revised down your projections for real GDP growth in 2018, yet at the same time we see that there is growing employment. Wages are rising faster than previously expected and there is a quite substantial improvement in the public finances. How can we have those positive outcomes when GDP growth has been worse than expected?

Robert Chote: The calendar-year GDP growth rate was not that much weaker than anticipated and most people were looking at something in the 1 to 1.5 per cent territory. That has proved to be broadly in the right ballpark. There was the particular issue last year of a weak first quarter because of the weather. Because of how you calculate the year-on-year growth rate, what goes on in the quarters immediately before and after the turn of the year has a disproportionate effect on the numbers compared with getting a surprise in the fourth quarter of the year. There is an element of that involved, so I would not overstate that point about growth rate.

As the numbers were evolving through last year, we were struck that most of the major tax streams—not just one of them—were kicking in considerably more money than was anticipated through this period so there seemed to be something more general going on.

One possibility that we raised in our October forecast report was that nominal GDP—the cash size of the economy—and not necessarily real GDP may have been growing more quickly than the official figures were suggesting at the time. If you think about the tax revenues that are coming in, we tax away a proportion of people's cash income and spending, not a proportion of what the statisticians choose to regard as real growth versus changes in prices.

In the latest set of numbers that the Office for National Statistics has produced in the past few days, it has indeed revised up its estimate of how quickly the cash size of the economy was growing through 2017, which would be consistent with that part of the story.

That said, there were a number of other features—for example, on the income tax side, where there were positive surprises in 2018-19 in the strength of those receipts that we would not expect to push through into future years and which we did not push through into future years in the forecast. Among those are policy changes such as the pay-as-you-earn refresh, which is trying to capture underpayment of income tax earlier. That has the effect of bringing forward receipts so you get more of them in the near term, but it does not increase the strength of receipts over the longer term.

As you say, within the composition of GDP, there was also stronger employment growth over the summer than people anticipated, so that would be an element of it as well.

Murdo Fraser: Thank you.

The Convener: Murdo—-no, Adam has the next question.

Adam Tomkins: You just confused me with Murdo, didn't you?

The Convener: Yes, I did. It is difficult to do that, but I managed it.

Adam Tomkins: I am afraid that I want to ask about Brexit. Your forecast was published in October, which was before the publication of the withdrawal agreement. You say in the forecast that, at that point, there was no "meaningful basis" on which to predict the outcome of what were then current negotiations, but of course there is now a meaningful basis. In particular, there is a meaningful basis on which to analyse the economic differences between this deal being accepted and the alternative being accepted, which is that the United Kingdom would be likely to leave the European Union on a no-deal basis. Can you help the committee to understand what the difference is from your perspective between the deal that is on the table and a no-deal Brexit?

Robert Chote: We have not done a direct comparison of those two alternatives. Last year, we set out in a paper the thinking that we would go through in analysing the eventual outcome. It is important to state that, although we are required by legislation to base our forecasts on current Government policy, we and the Government interpret that as meaning policy that it is in the Government's hands to deliver and ensure is in place. Obviously, there is still doubt about where we will be at the end point of this process. As you point out, Brexit could happen on the basis of that agreement; there is the possibility of a no-deal exit; or something else could happen, including some delay in the process.

In relation to our thinking about what the impact of a no-deal exit might be, there was some useful analysis from the Bank of England towards the end of last year. It produced assessments that on the one hand pointed to what in the bank's view were differences in the growth prospects that would result from greater or lesser continued engagement with the EU and closeness of trading relationships in the long term, but it also produced a couple of scenarios based on a disorderly or disruptive exit.

Although, needless to say, everybody leaps to the most interesting of the sets of numbers that were produced, the Bank of England was very clear that the scenarios were in a sense used for stress testing the health of the financial sector under those circumstances; they were not a specific forecast. In particular, it said that its worst-case scenario was just that and not a central forecast of what would happen under the circumstance that there was no deal.

If we look at the paths that the Bank of England set out, a couple of things are striking. First, a disruptive exit would be a very unusual sort of shock to hit the UK economy, for which there is no good precedent in this country or, indeed, in other countries, such as economists would normally draw on in looking for the closest examples in the past from which to draw conclusions. In all probability, the shock would simultaneously be negative or damaging both to demand in the economy, or the willingness of consumers and businesses to spend, and, particularly importantly, to the supply capacity of the economy, or its ability to produce goods and services and distribute them.

As I say, it is hard to look back to instances in which we have seen such a shock in the past. In evidence to this committee's Westminster counterparts, my colleague Charlie Bean highlighted the three-day week as an example in which there were relatively abrupt quantity constraints on what the economy was doing. The fiscal implications are affected by the uncertainty around how big the initial hit will be. The two scenarios in the Bank of England's analysis—which, as I said, was not a distribution around a particular set of probabilities—looked at near-term hits to GDP of 3 per cent and 8 per cent.

There is obviously uncertainty about how big the hit would be, but key to the fiscal implications is how persistent the effect would be. It would clearly be of much more concern to somebody thinking about long-term fiscal planning and public expenditure if the shock had a long-lasting effect and permanently moved the economy down to a significantly lower trend path of activity than we would otherwise expect, compared with the basis of a really bad six months in which economic activity went down and then bounced back—although not all the way back to where it would have started. There are those two possibilities and neither of those judgments is an easy one to base.

As Susan Rice said, a lot would depend on the exact nature of the disruptions, the mitigating measures that the UK Government was able to take and the attitude that other EU countries took—how accommodating they were of those sorts of constraints as they came up. There was an interesting discussion with Ms Constance about when we will know. Obviously, we will be in the process of producing a forecast and, if we have to use a no-deal outcome as a central expectation, we will try to do that.

I warn the committee that, even when you start to get the outcome data—not the forecast, but what the ONS and other people tell you about what was happening through that process—those will be very early drafts of economic history. The initial indications of what has happened to the economy over a one, two or three-quarter period may look very different with the passage of time. It will certainly pop into the next forecast. I looked back at the range over the past 25 years of what the ONS thought happened in the first quarter of the three-day week. The outturn estimates—not the forecasts—varied from 3 per cent to 1 per cent in how much they said it had hit the economy, and the numbers changed for years after the event.

I would urge caution because, even if we enter into the process, we have the uncertainties around forecasting in the near term what the hit will be and how persistent it will be. Another challenge is that I will come back to you in a year's time and say, "This is what the outturn data shows at the moment, but we need to put an enormous dollop of salt on it, as the official statistics might paint a different picture in a few years' time."

11:30

Adam Tomkins: That is helpful, and slightly anticipates my supplementary question. You said in the executive summary of your "Economic and fiscal outlook" of October that a "disorderly" Brexit, by which I assume you mean a no-deal Brexit, would have

"severe short-term implications for the economy, the exchange rate, asset prices and the public finances."

When you wrote that, you did not have anything to compare a no-deal scenario with, but you now have that, because we have a comprehensive 585-page withdrawal agreement, which has been in the public domain for a number of weeks. Can you tell us anything about how much more severe the implications for the economy, the exchange rate, asset prices and the public finances a no-deal Brexit would be when compared with the withdrawal agreement?

Robert Chote: Not really, because of the considerable degree of uncertainty about what the no-deal scenario would look like. As was said earlier, it is not clear that the withdrawal agreement, were it to pass through Parliament, would be an outcome that lies outside the range of possibilities that is in effect incorporated in the current forecasts. Obviously, a lot of the interest in the issue relates to the effects of not just the withdrawal agreement but the end-state trade relationship and the long-term migration policy that we end up with. Those things will have an effect over a far longer horizon than the five years that we are looking at—

Adam Tomkins: I am sorry to interrupt. I understand that, but in the very short term, politicians have a decision to make about whether to back the deal that is on the table. You have helpfully said that the consequences of a disorderly Brexit will be "severe" in the short term

"for the economy, the exchange rate, asset prices and the public finances."

We now have something to compare that scenario with. It would be helpful if you could assist us in understanding the magnitude of the difference between the deal that is on the table and the alternative to the deal on the table, which, as the law stands, is that we leave the European Union on 29 March with no deal. How much assistance can you give us on that specific question?

Robert Chote: I can reiterate the point that a disruptive outcome would be a lot worse than an outcome that is not disruptive. At the moment, our forecast and the SFC's forecast are predicated on a non-disruptive outcome, and the withdrawal agreement is consistent with the range of possibilities that are taken into account on that basis. The bigger uncertainty is not about the difference between what either of us assumes now and what we would assume if the withdrawal agreement went through completely; it is about the difference between what we assume now and the wide range of possibilities for what a disruptive exit could look like.

It is important to draw a distinction between a no-deal situation that leads nonetheless in a relatively orderly way to a relatively distant trading relationship with the EU on a World Trade Organization scenario and the sort of exit that implies severe near-term supply constraints—the queues-on-motorways type of scenario. That is a very different situation. As I said, we do not have good historical precedents to draw on for that and we do not know until we get there what mitigating measures it would be possible to take or what measures would be taken on the other side of the Channel.

The summary is that a disruptive outcome would be worse than a less disruptive outcome, and people should certainly take that into account.

Adam Tomkins: The other take-home message is that backing the deal avoids those short-term severe economic implications that you have identified. That is helpful—thank you.

Robert Chote: As you know, that was not a recommendation as to how people should vote, one way or the other. That matter is way above my pay grade.

The Convener: It is helpful, though, because it ensures that, once the deal falls next week, there will not be a situation in which we have no deal.

Angela Constance has a supplementary.

Angela Constance: I have a few supplementary questions. It is interesting that a lot of experts in front of the committee talk about a "disruptive" Brexit or a "disorderly" Brexit but do not use the phrase "no-deal" Brexit. I wonder whether that is because any Brexit is on a spectrum of disruption. You have talked about more or less disruption. There is nothing about the process that is not disruptive or indeed damaging.

You spoke about reducing demand in the economy and a disruptive effect on the supply of goods and services on top of the potential risks to exchange rates, asset prices and public finances. Could you put some of that into human speak and indicate what it means for ordinary people going about their daily lives? Are we looking at food shortages, three-day weeks and queues on the motorways? What will it mean in real life?

Robert Chote: I can do no more than point to the sort of analysis that the committee will have seen from the Bank of England and other institutions. Forecasting the nature of the disruption is not part of the OBR's remit. Disruption to the ability of the economy to produce goods and services and get them distributed will clearly have an impact on daily lives as well as on relatively abstract economic statistics. It is another reason why it is difficult to provide a quantitative estimate of what Brexit is going to mean in terms of the value added in the economy from one quarter to the next.

The other issue is that we do not know how policy would respond to such events. The Bank of England has spoken a lot about the challenges that it would face. It is not like the referendum vote, which the bank perceived as a blow to people's confidence and their willingness to spend, in relation to which it could buoy up confidence by what it did on interest rates and other monetary support for the economy. The bank has pointed out that, if the country is hit by a shock over people's ability to get work and to get the products that their businesses produce to their customers, that is a different sort of economic blow and not one to which the automatic policy response is to take measures that encourage people to spend more.

Angela Constance: In paragraph 1.16 of the executive summary to the "Economic and fiscal outlook" of October 2018, the OBR refers to how the economy has already been weakened as a result of the EU referendum. You said that

> "The fall in the pound has squeezed real household incomes and consumption",

and that business investment has been "dampened". Will you say a bit more about how the referendum result has already hurt our economy and about the implications of that?

Robert Chote: Yes; that is the conclusion that we and I think most other people have reached. The classic problem here is that we cannot know with confidence what the world would have looked like had the referendum vote never taken place.

It is possible to think about the task of quantifying the effect in a couple of ways. One is that we had a forecast prior to the referendum, assuming that there would be a vote to remain in the EU, that the economy would grow by roughly 4.5 per cent between the time of the referendum and now. In the first forecast that we produced after the referendum, we reduced the figure to about 3 per cent. The latest outturn data suggests that growth has been about 3.2 per cent. Those figures are consistent—it is not a spot-the-ball competition. The numbers could be revised and look different, but the picture is consistent.

The other way to approach the task is to look at the behaviour of other economies relative to the UK to identify a doppelgänger economy for the UK, by saying, for example, that the UK typically grows and performs 40 per cent like France, 10 per cent like Hungary—or whatever basket of countries that one uses. How the basket of countries continued to perform after the referendum can then be compared with how the UK has actually performed. That gives a rough picture of what might be thought of as how the UK would have done had the vote not gone the way it did.

I can think of two or three economists or analytical groups that have done that sort of analysis, and they tend to suggest that the economy is 1.5 to 2.5 per cent smaller than it would otherwise have been. Again, that is consistent with the picture, particularly the relative weakness of business investment in the wake of the referendum and the fact that the boost to net trade from the fall in the exchange rate has not been as great as some people anticipated.

There is clearly an enormous amount of uncertainty around that, but the fact that we have numbers of that magnitude is broadly consistent with the changes in our forecast picture and the fact that the world economy did better than we anticipated in the period immediately after the referendum. In a sense, we should have outperformed pre-referendum expectations purely as a result of that better global scenario, but that did not happen.

It is a broad picture. It looks as though the economy is weaker than it would otherwise have been, but the precise magnitude is clouded by considerable uncertainty.

Angela Constance: The World Bank has produced some interesting analysis of Brexit today, and we also need to consider what is happening with China and the US and trade sanctions. When we look to the future and what will happen next, none of it looks good. You have spoken about how you will assess changes in circumstances as they become apparent. I am interested in the impact on the tax take and other consequences of Brexit, particularly in relation to migration, which we have already discussed this morning.

The current UK proposals in the white paper, which are being consulted on, would reduce our working-age population. EU migration could reduce by 80 per cent, which would have an impact on real GDP in Scotland, reducing it by 6.8 per cent by 2040, and reducing revenues over the period by £2 billion. What analysis of that have you done to date? How will changes in migration and the tax take feature in future work that you will do?

Robert Chote: Before the Brexit issue came along, we already had to take some account of the prospective outlook for the population in all our forecasts. That is crucially affected by migration flows, but it is also affected by other things, such as mortality and longevity. Again, the big picture conclusion is that, over a medium to longish horizon, lower net inward migration is a net negative for the public finances, primarily because inward migrants are more likely to be of working age than the population as a whole.

From time to time, we have to decide which of the available population projections that the Office for National Statistics produces we should base our forecasts on. If the referendum vote had not gone in the way that it did, I think that we would have been inclined—on the basis of what were then recent outturn data—to have moved to assume a higher flow of net inward migration, simply because it had been higher than the official projections had suggested previously. The judgment that we took in November 2016 was that we should stick with the principal population projection rather than adopting one that went to higher net inward migration flows. As we set out in the forecast, that has the impact of weaker growth in incomes, profits and spending, and therefore a weaker position for the public finances.

When we get down to a firm position on what the future migration policy will be, we will need to take into account what it means not just for the volume of the flows, but for their composition. The forecasts that we have done to date have been based on the relatively simple assumption, which is consistent in broad terms with the available evidence, that the characteristics of a net migrant in terms of their likely productivity and employment prospects are the same, adjusted for wage and gender, as those of the native domestic population.

11:45

In the event of such a change in migration policy, we would have to ask ourselves whether it was sufficient to assume that the net migration flow post the policy change would have a higher productivity consequence than the existing population. Given that we are talking about the flows in and not the stock of people who are in the country, I suspect that the quantitative effects of going down that path would be relatively modest. As has been discussed, the implications of changes in migration could be more significant for particular areas and industries than for the aggregate picture, but I doubt that the effect on the aggregate picture would be huge.

Angela Constance: Scotland's population growth is predicated entirely on positive EU migration. I am keen to know whether you have analysed or will analyse the UK Government's migration white paper that was published over the Christmas period. Your executive summary makes an effort to scope potential changes to the national living wage, which will be consulted on. As part of horizon scanning, you looked at those proposals, so will you look in detail at the implications for the UK and for Scotland of the UK Government's migration proposals?

Robert Chote: If and when the Government adopts and proceeds with those proposals, we will incorporate them in the forecast.

Angela Constance: But you have done such work. As an aside, I think that a lot of people would disagree with what paragraph 1.28 of your executive summary says would be the implications for employment of increasing the national living wage. You did that work on a policy that is still vague—nobody knows whether it will happen. You say that you have not done similar work on the migration proposals because they have not been adopted, but a consultation paper has been issued.

Robert Chote: That is a fair point. It is fair to say that the firmness of the living wage policy was determined relatively late while we were writing the document. Whether it would have received the same coverage if we had known the emphasis that would be placed on it is an interesting question.

As for the likely quantitative impact over our forecast horizon, we take such issues into account, but that involves determining matters once the policy has been implemented. In such areas and in welfare reform, too, a clear objective may be set, but the questions are about how long it will take to implement the policy, whether the process will work in practice and whether people will be in place to implement it over the expected time horizon.

Our fingers have been burned many times when we have assumed that welfare reforms that had been announced would be introduced on a particular timetable but they have in fact taken three times longer to get there. In addition to having a relatively high-level statement about what a future policy might look like, we would want to drill down much more into how the policy would be implemented in practice.

Patrick Harvie: Good morning. I am sorry to keep you on Brexit for a little longer, but I—at least—have one last point on it. We all acknowledge the scale of uncertainty and chaos that this mess has created, which includes the fact that the House of Commons appears to have majorities against all the specific paths but no majority yet in favour of anything specific. However, to ask you only about the forecasting differences between the withdrawal agreement and a no-deal scenario, as Adam Tomkins did, would be incomplete. There is the potential for a different path to be taken, whereby the public are asked whether they want to think again and cancel Brexit. Obviously, I will not ask you to comment on the merits of that path. However, the possibility exists.

If that path were taken, would we simply be in the position of setting aside the range of scenarios in terms of economic forecasts and public finance projections, or would the OBR and, I presume, the Fiscal Commission say, "Hang on. We need to go back and work out from scratch what those forecasts will look like in a no-Brexit scenario"?

Robert Chote: It would clearly be too simplistic an approach just to look back at the last table that one had put in a report that said what the effect would be if we went in one direction and to then take it all out again. Of course, one would have to make judgments about the implications of a move in that direction for business and consumer behaviour, and one would pretty swiftly see the scale of reaction in financial markets—in the exchange rate, equity prices and so on. It would not be a question of leafing back through the document, finding the last set of numbers that one had put in and hoicking them out again. It would not be like that scene in "Dallas" where the character gets out of the shower and it was all a dream. [*Laughter*.] We would still be located in real time, several episodes on in the drama, and we would have to start writing the script from that point.

Patrick Harvie: How long would it take for that work to be done? If we are assuming that all the Brexit scenarios are harmful, how long would it take to figure out the new situation that we would be in as regards the future public finances?

Robert Chote: In the analysis that we do, our producing a forecast is constrained by the timetable that is dictated by the UK Government's choices about when to have fiscal events. Obviously, as you saw last year, the choices about when to have those can be affected by the timetable, too. In a sense, we would be prisoners of the UK Government's decision about when it wanted a fiscal event, and how much information there was and how robust it was at the point, some way in advance of that event, when we would have to start closing the forecast down.

The Convener: You guessed that a lot of the discussion would be about Brexit. If there are no more supplementaries on Brexit, we will move on to digital matters.

Willie Coffey: In paragraph 1.41 of the OBR's executive summary, there is mention of the Government's intention to introduce a new tax on "large digital businesses". Has a forecast been made of the impact or value of that new tax?

Robert Chote: I think that, at this stage and at this level, we would do no more than produce the policy costing on the basis of the measure that was announced. In such areas, we need to see how things will crystallise in practice; we need concrete information on issues such as exactly which sorts of firm will be affected and what the basis will be, if we are to come up with a relatively robust estimate.

As you can appreciate, even when we have firm details of a new tax, there is always a much greater degree of uncertainty about expectations of receipts from a new measure than there is about the receipts that will come from tweaking an existing one. Given the population of firms that would be likely to be affected by the measure that we are talking about, that would be true in spades.

Willie Coffey: That relates to the broader issue, which is that we will be leaving the digital single market, as the Prime Minister said almost a year ago. Since she made that comment, has any modelling been done of the potential impact? We know that an increasing number of information technology companies—and other companies—are beginning to move their operations from the UK to Europe. Have you modelled the impact of that on the tax take?

Robert Chote: We have not done anything on that sort of sector-specific basis. I do not know to what extent the Treasury drilled down into that sector in the analysis that it did that came out at the end of last year, which I think contained more sectoral analysis than, for example, the Bank of England's analysis did. That is where I would point you to on the official side. It is not something that we have done; our forecasts of corporate tax receipts, as with most of our forecasts, are done in a more top-down way, rather than being built up from specific sectoral views.

Willie Coffey: Could we get hold of some of that forecasting?

Robert Chote: We can check whether anybody back at the office is aware of other people who have done it. I do not know whether it has been done by people at Oxford Economics, for example, who do more sectoral forecasts in addition to a broad macro forecast. It is possible that, in the unofficial sector, somebody like that has done more sectoral forecasting. If anybody is aware of that, I can certainly get back to you.

Willie Coffey: Thank you.

Tom Arthur: Good morning, Mr Chote. This question is similar to one that I asked the SFC witnesses about average earnings. The UK as a whole has quite an unbalanced economy compared with that of some fellow members of the Organisation for Economic Co-operation and Development, particularly with the economic concentration in south-east England. Given that average earnings will be inflated to an extent by sectors such as the financial services sector in the City of London, does that create a degree of volatility when it comes to calculating and forecasting what average earnings will be?

Robert Chote: Yes. One way to calculate average earnings is simply to look at the overall amount of labour income divided by people, but to inform what is going on in the likely path of tax revenues, we are also interested in what might be going on in the distribution, simply because wage growth at the top delivers bigger increases in tax revenue than wage growth at the bottom. Looking over recent years at the degree to which people are brought in at the bottom, one of the striking features is that we are not getting that much more revenue from the growth in self-employment et cetera, which is also part of the story.

One area where we might start to see more useful and timely information than we have had available to date is HMRC's real-time information data source. HMRC is bringing more of that into the public domain as it becomes happier with its robustness. At the moment, it is a data source that the SFC and the OBR look at but do not bet the farm on. However, it could give a more granular view of what is going on with the pace of wage growth at different points in the income distribution. I think that you discussed in the previous evidence session the issue of whether some of the growth in the relative strength of income tax receipts in the rest of the UK might have been down to the fact that there was more rapid growth at the top, which is certainly a plausible path, but the RTI data over time might be the best data that we can draw on.

Tom Arthur: Do you have a sense of when that RTI data will start to become available? I am thinking ahead to the negotiations on the fiscal framework that will occur in the next few years. Given the block grant adjustment mechanism, the forecasts for income tax take in the rest of the UK—or, as it will be in a few years' time, England and Northern Ireland—will have a significant bearing on the money at the disposal of the Scottish Government. I am keen to get an understanding of that. London is such a unique city—in effect, it is a city state bolted on to an above-average European economy—that it creates a distorted picture. Will the more granular detail of the RTI data be available within the next few years to inform the deliberations of the Scottish and UK Governments when they negotiate the fiscal framework?

Robert Chote: It will become more available over time. However, I am not sure whether the Governments will believe that the regional and national breakdowns of that are robust enough to lay particular weight on. I can imagine the Governments being happier to put national aggregate numbers out before they would be willing to do it at another level, but you would have to ask them about that. As I said, it is an area that is telling us some interesting things at the moment, but we would be cautious about placing too much weight on it too early.

Tom Arthur: Thank you.

The Convener: Can I take you back to the beginning of the discussion, Mr Chote, when James Kelly asked questions about issues to do with tax revenues and growth et cetera? According to the latest forecast, the gap between Scottish income tax revenues and income tax BGA is expected to grow, albeit very slightly, in each subsequent year of the forecast period from 2020-

21 onwards. However, that is despite the fact that Scottish earnings are forecast to grow more slowly than the OBR forecasts for UK earnings. Are you in a position to explain that contradiction?

12:00

Robert Chote: Again, the choice of how to calculate the block grant adjustment is way above my pay grade. I suspect that we are taking a relatively top-down view that is based more on the UK aggregates and our view of what is going on in the labour market across the UK, and then coming to a view on the share of receipts that applies to Scotland, whereas the Scottish Fiscal Commission is focusing more on its growing amount of forecasting at a Scotland-specific level. If the gap that you describe is reflective of the gap between our forecast for income tax and the Scottish Fiscal Commission's forecast for income tax, its relatively weaker view of earnings growth and productivity growth probably underlies that.

On the income tax side, to come back to the committee's earlier discussion, we find ourselves in the interesting situation in which we have had to make a relatively large revision of our estimate of the Scottish share as a result of the 2016-17 outturn data coming in at a considerably lower level than the "backward-looking" forecast of that. That is an area in which we hope we will have more useful information coming up for the next forecast that we produce in the spring, because we should have the 2016-17 SPI to compare against the outturn data. That should shed some light on some of the starting-point issues—in particular, whether the difference between the outturn data for 2016-17 and what we had inferred from the previous year's SPI is reflected in the fact that there is a difference between what those two measures show or whether it is simply the case that there was a big move between the 2015-16 SPI and the 2016-17 SPI. It should shed some light on whether people's behaviour with regard to the migration and residency issues that the committee discussed earlier was affected.

In relation to that earlier debate, I sound a note of caution. It is tempting to think of the SPI as a sort of rough stab at the true share and to think of the outturn data that is based on the flagging of taxpayers as the right answer, but we cannot yet be confident of how long it will take for the flagging process to bed in. The share that is shown up in the outturn data could take some time to settle down as HMRC gets to grips with whether it has the right people flagged in the right way, so a lingering uncertainty will remain for some time.

The Convener: That is very interesting. Could you expand on why that is proving to be a problem?

Robert Chote: We do not yet know whether that is a problem. It might be concluded from the outturn data for 2016-17 that the SPI for 2015-16 must have been wrong in some way, but both numbers have uncertainties around them. With the SPI, we have all the uncertainties that are related to the fact that it is a sample, so it does not look at the whole population, which raises a question about whether it is representative of the whole population. With the move to flagging, there is the issue of how people are picking that up and how they are choosing to define their residency and their taxpayer status. That might take some time to settle down, and there is the issue of how much HMRC feels that it has to do to check whether people have given it the right answers.

When we get the SPI for 2016-17, it will be interesting to look at whether there is a difference that is unrelated to behaviour between the postcodes that are used in the SPI to identify where people are as taxpayers and what people have told HMRC in the outturn data. The fact that there are differences does not necessarily mean that people are lying or being disingenuous; people might simply be responding. When we get that, it will provide us with useful and interesting information, on which I hope that we will be able to shed some light in the spring forecast. I know that commission colleagues will want to look at that over the coming year. However, I am slightly hesitant about the view that the outturn data provides absolute clarity on what the share is. Again, it is an estimate.

The Convener: That was helpful. We will need to take a much closer look at the SPI numbers when they come out in the spring than we might previously have thought, just to make sure that the figures from both sources are going in the right direction.

Robert Chote: Yes. As I said, looking at those differences will shed some light on the issue, but it will not provide all the answers on what has been going on there. Whether there is a constant wedge between those two sources of information or whether, over time, they are moving in ways that we need to take account of is certainly an issue that we will look at, and I know that the commission will want to look at that, too.

The Convener: As colleagues have no further questions, I want to thank you very much for coming along and sharing your expertise with us. It has been very helpful to gain an understanding of some of the work that the OBR has been undertaking. As well as providing factual information, you bring humour to such occasions. I remember that, on the first occasion on which you appeared before us, you talked about how relevant spot-the-ball competitions were to forecasting, and today you mentioned the shower scene with Bobby Ewing. [*Laughter*.] Those are things that I will be able to quote all over the place for a long time to come, so thank you very much.

Robert Chote: Humour over substance is all that I can offer, I am afraid, but thank you.

12:05

Meeting continued in private until 12:05.

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