OFFICIAL REPORT
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Finance and Constitution Committee

Wednesday 5 June 2019

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Pàrlamaid na h-Alba

Session 5

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FINANCE AND CONSTITUTION COMMITTEE
13th 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:

John Ireland (Scottish Fiscal Commission)
Dame Susan Rice (Scottish Fiscal Commission)
Professor Alasdair Smith (Scottish Fiscal Commission)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Finance and Constitution Committee

Wednesday 5 June 2019

[The Convener opened the meeting at 10:04]

Economic and Fiscal Forecasts

The Convener (Bruce Crawford): Good morning and welcome to the Finance and Constitution Committee's 13th meeting in 2019. We have apologies from Murdo Fraser, who is speaking to amendments to the Transport (Scotland) Bill, and I should also say that Neil Bibby might have to leave at some stage for the same reason. Finally, I remind members to put their mobile phones and so on in a mode that will not interfere with proceedings—I had better do that, too.

Agenda item 1 is consideration of the Scottish Fiscal Commission's economic and fiscal forecasts, which were published last week to accompany the Scottish Government's medium-term financial strategy. I warmly welcome from the commission Dame Susan Rice, chair; Professor Alasdair Smith, commissioner; and John Ireland, chief executive.

Would Dame Susan Rice like to make an opening statement?

Dame Susan Rice (Scottish Fiscal Commission): Yes, convener. Thank you for inviting us to give evidence again. In addition to my colleagues who are here, there are two other commissioners—Professor Francis Breedon and Professor David Ulph—but I must give you their apologies, as they cannot join us this morning.

I will give the committee a generic update. Since we appeared before the committee in January, the commission has completed its second year as a statutory body. I am pleased to say that we have signed a memorandum of understanding with the Department for Work and Pensions on access to data on social security, and I am grateful to the civil servants at the DWP and the Scottish Government who helped us with that. The committee will remember that in January we had just signed a formal MOU with the Office for Budget Responsibility, and we are now about to sign a revised MOU with Her Majesty's Revenue and Customs. That is all really good progress.

As members know, our founding legislation required us to be externally reviewed at the end of our second year. I am pleased that the Organisation for Economic Co-operation and Development has agreed to do the review for us, along with several international experts. The review team will be in Edinburgh next week, and I am grateful that a couple of committee members will meet the team on Tuesday morning.

As the committee knows, we publish our forecasts twice a year—in May to support the Scottish Government's medium-term financial strategy and in December to support its budget. The latest report contains our economy, tax and social security forecasts as usual, but what is a little different is that we have put more emphasis on an analysis of key issues that the Scottish budget faces.

At budget time in the winter, everyone's attention is on tax and spending plans for the year ahead. What is good about the summer and the most recent forecast is that, as the immediate pressure of setting a budget is behind us, we can spend time thinking about the longer term. our forecasts look ahead for the next five financial years, and we also add a financial year to our forecasts—this time, it is 2024-25.

Our report highlights two longer-term risks to the Scottish budget. The first arises from the devolution of further social security benefits in April 2020, which is less than a year away. Our estimate of the spend on social security next year is £3.5 billion, compared with the £447 million that we expect to be spent this year. The forthcoming benefits are demand led—in other words, anyone who applies and is eligible for them must be paid—so the Government will need to manage in-year any difference between the forecast and the spend.

As context, I point out that the Government's entire spend this year on its justice portfolio, which covers police, fire, court and prison services, is £2.7 billion. Members will see, therefore, that £3.5 billion is a great deal of money. What makes the situation trickier is that forecasting the spend on new benefits that are to be administered in a distinctively Scottish way and possibly under different eligibility rules is much harder in the first few years, as we do not have an established baseline to work from.

The second risk that we highlight involves adjustments that the United Kingdom Treasury will begin to make to the block grant, which will for the first time reflect the income tax that is collected. We estimate that the adjustments—or reconciliations, to use the technical language of the fiscal framework—will reduce the Scottish budget by £229 million in the next financial year and by £608 million the year after.

The reconciliations arise from the use of two sets of forecasts when the budget is set—our revenue forecast and the forecast of the block grant adjustments, which is based on OBR forecasts of receipts by the UK Government. As we all know, forecasts are never entirely correct, but the budget must be based on the best possible estimates of what will be raised and spent. I suspect that the committee will be interested in why our estimates of the reconciliations are the size that they are, and we can explore that issue with you. As we said in our December report, given the OBR's track record, we might see errors over time as large as 3.3 per cent, which in the Scottish context is about £530 million. That gives members a sense of what might evolve.

Our analysis of reconciliations is based on the most recent forecasts by us and the OBR. This summer, income tax outturn data for 2017-18 will be published. In our September forecast evaluation report, we intend to present a detailed analysis of the actual reconciliations, which will be a subject for fruitful discussion.

As far as the Scottish budget is concerned, what is probably most important for the Government is its decisions on how to manage any volatility in the reconciliation number. The Government can borrow and use its reserves to deal with the reconciliations, but it might also have to consider adjusting its spending plans.

With regard to the prospects for the Scottish economy, I said in December that Brexit was at the front of our minds, and that has continued to be the case. When we started in March to work on the current forecast, we thought hard about how we would deal with Brexit. As in December, this forecast is based on a broad assumption of an orderly and negotiated exit from the European Union, which we now assume will happen in October, rather than March.

The terms on which the UK might leave the EU are still highly uncertain. We have made a number of broad-brush assumptions to capture a range of possible outcomes. Although a no-deal exit is not captured in our central assumptions, it is a significant downside risk to our forecasts.

We followed the many twists and turns of Brexit as we put our forecasts together. We finalised our approach at the beginning of last month, when the Scottish Government needed our final forecasts to do its work. Things have moved on since then—most recently, we have had the Prime Minister's resignation announcement—but we believe that our Brexit assumptions are still a reasonable basis for our forecasts.

Thank you for your attention to that overview. We welcome the committee's questions or thoughts.

The Convener: Thank you for your statement.

You mentioned the forecast of income tax reconciliations, and we will need to get into that issue first. Something about it puzzles me. Despite Brexit and the fact that population growth is projected to be slower in Scotland than in the rest of the UK—two elements that are largely outwith Holyrood's control—the Scottish economy is still growing, the unemployment rate in Scotland is lower than that in the rest of the UK and our tax take continues to grow. However, under the forecast of income tax reconciliations, we will end up with less money. That is not how a normal economy works, so we clearly need a bit more of an understanding of something in the system. For the benefit of the committee and interested people watching the proceedings, will you give us the commission's perspective on the situation?

Dame Susan Rice: It is an important question, and we have spent a lot of time considering how to articulate a response to it. I ask Alasdair Smith to kick off.

Professor Alasdair Smith (Scottish Fiscal Commission): I will have a go. The reconciliations process is complicated—it involves lots of moving parts, and it is hard to keep an eye on all those parts and line them up in the right way at any point. However, I will do my best.

As Susan Rice has said, the key starting point is when the Scottish budget is set. I will take the 2018-19 budget as an example, because it involves the biggest reconciliation. It was set in 2017 on the basis of our forecasts of income tax revenue and the OBR's forecasts for the UK economy, which feed into the block grant adjustment.

As the convener said, because the Scottish economy is growing, we would expect Scottish income tax revenue to grow, and that is the case. Because the UK economy is growing, we would expect that to feed into the calculation of the block grant adjustment. We forecast growth in Scottish income tax revenue and the OBR forecast growth in UK income tax revenue, and both forecasts went into the calculation of the 2018-19 budget.

10:15

As Susan Rice emphasised, we are still looking at what we expect to happen when we find out the outcomes. The income tax outturn for 2017-18 will appear in July this year, and the outturn for 2018-19 will appear in July next year. We are looking at what seems likely to be the case with those outturns. We still expect Scottish income tax revenue and UK income tax revenue to have grown over the period, but Scottish income tax revenue will have grown at a slightly slower rate than we expected, whereas UK income tax revenue looks to have grown at a much faster rate than was put into the BGA forecast.

The reconciliation is not really about the performance of the UK and Scottish economies but about the accuracy of the forecasts. If the forecast errors—I use the word “errors” carefully, as no forecast is accurate—had been the same on both sides, there would be no reconciliation. The issue is not whether there were big forecast errors because, if we had the same forecast errors as the OBR, there would be no problem. The reconciliation is needed when our forecast adjustments are out of line. It is not really about the Scottish economy’s performance but about the adjustments in the forecasts that seem likely to be appropriate.

The Convener: I understand all that, but that does not explain why we will lose money as a result of the forecast income reconciliation. Is it right that much of the unexpected additional growth, which is higher than what the OBR projected, has been the result of increased earnings in the rest of the UK?

Professor Smith: You are absolutely right that the single biggest factor in the size of the reconciliation is that UK tax revenue has risen faster than was expected when the budget was set. That is the most important comparison. UK tax revenue has grown faster than was forecast, whereas Scottish tax revenue has grown slightly more slowly than was forecast, although the gap is not big. The growth in UK tax revenue is the reason why the block grant adjustment is bigger than was forecast two years ago.

The Convener: In our budget report in January, we began to explore the issue, with questions asked by me, Adam Tomkins and Murdo Fraser—who, unfortunately, is not with us as he is at another committee meeting. We suggested in the report that there is evidence that differences in income tax growth might be

“due to the disproportionate level of higher taxpayers in the rest of the UK relative to Scotland.”

If that is the case, does that suggest that the fiscal framework’s operation has a flaw that will need to be addressed when the framework itself is reviewed in 2021? Otherwise, we will be in a competition that we cannot win.

Professor Smith: It is not for the commission to make judgments about how the fiscal framework should be changed—that is for Parliaments and Governments to decide. You are right that the likeliest single explanation of the issue is that the rest of the UK has a higher concentration of higher-rate taxpayers and that the recent growth in UK income tax revenue has been concentrated among them. The issue is not just the distribution but the fact that growth seems to have come disproportionately from that group. In our forecast evaluation report in September, we will look at that more closely.

However, that situation is not a fundamental flaw. If we and the OBR had expected it two years ago in setting our forecasts, we would have taken into account the distribution of Scottish taxpayers in forecasting the growth in Scottish income tax revenue, and the OBR would have taken into account the distribution of UK taxpayers in forecasting the growth in UK income tax revenue that went into the block grant adjustment.

None of us was aware that the growth in income tax revenue in the two years would be so strongly affected by distributional issues. With the benefit of hindsight, we would make different forecasts. Does that mean that a fundamental flaw exists? No. If we had known about the situation, the budget would have been set on that basis, so Scotland would have had a smaller budget two years ago and we would not need a reconciliation now. The situation is not a flaw—

The Convener: There was no flaw in what you were doing.

Professor Smith: No. I have said that it is not for us to pronounce on the fiscal framework, so I should not say that this is not a flaw in that framework. Perhaps I should say that there is no particular reason to think of it as a flaw. Such adjustments are the normal business of forecasting. Not thinking about the distribution of higher-rate taxpayers in Scotland versus the distribution in the rest of the UK is a twist that neither the OBR nor us would feel is a terrible mistake—although, with the benefit of hindsight, we might feel that we could have done a slightly better job on that.

However, that is the normal business of forecasting. Two years after any set of forecasts, we can find things that could have been done better. The most important message is that the scale of the forecast corrections is not out of line with what would be expected to arise from putting together forecasts from two forecasters that are doing a pretty good job of forecasting. Nobody will get forecasts right; the message is that the Scottish Government must be ready to deal with reconciliations on such a scale, although we hope that they will not be £600 million every year and that they will not always be negative. They will be positive in some years.

In short, the scale of adjustment is not out of line with what would be expected from how the framework is set up. I am sorry if I have talked too much, but the issue is complicated.

The Convener: All that said, your report still forecasts a £229 million problem for the Scottish budget. That might not be much in forecasting, but it is a lot of money, and we need to get underneath why such reconciliations are to happen. If there is a structural problem that relates to earnings and the number of additional-rate and higher-rate taxpayers in Scotland in comparison with that in the rest of the UK, such a reconciliation might not be a one-off.

Professor Smith: If what you describe is the issue, we will feed it into our forecasts in the future. Forecast errors do not reproduce themselves, because forecasters learn. We would take such an issue into account in future forecasts.

John Ireland (Scottish Fiscal Commission): It might help to separate out the two aspects. The convener is right that what Scotland will get through the process depends on the structural difference between the rest of the UK and Scotland, but the reconciliation issue is not about that. As Alasdair Smith said, the reconciliation is about comparative forecast accuracy.

The convener is right that there is perhaps a structural issue with regard to the labour market in Scotland and that in the rest of the UK. In the end, that will wash out and affect how much Scotland gets, but that does not influence the reconciliation at all, as that is about forecasting.

The Convener: The baseline that we started from means that from here on in we will be £229 million out every year.

Professor Smith: No—we will be £229 million down in 2017-18, according to the forecast.

The Convener: If the issue is structural, how will that change?

Professor Smith: This autumn, the Government will set the budget for 2020-21. I imagine that, when that is done, we will all be aware of the implications of the distributional issue for our income tax revenue forecasts and the BGA forecasts. Those factors will feed into the forecasts, which might mean that the 2020-21 budget is less favourable than it would otherwise have been. However, if we get the forecasts right, there will no longer be a reconciliation issue, as the figures will be in the budget.

The Convener: I know that Adam Tomkins has questions, but I want to burrow down into this a bit further. We have looked at HMRC's forecast of additional-rate and higher-rate taxpayers, which you built your modelling on. It forecast 18,000 additional-rate taxpayers but, when we got the outturn data from HMRC, the figure was 13,300. If the 18,000 taxpayers who were in the system to begin with had a 3 per cent increase in their wages, that would mean a heck of a lot more money than if 13,300 taxpayers had such an increase. A problem has inevitably been built in from the beginning.

John Ireland: As Alasdair Smith has said, the way in which the issue manifests itself will show up in our future forecasts. It is important to separate out the two aspects. You are right that there is a structural issue, but it does not manifest itself as the reconciliation issue. The structural issue that needs to be worried about and which you are thinking about is to do with the devolution of income tax, which is not our bag—it is your bag.

The operation of the reconciliation is about relative forecasting accuracy. The OBR forecasts that determine the block grant adjustments and our forecasts take account of the outturn data, and both have been adjusted downwards by £550 million to reflect that. The outturn data showing a reduced number of income tax payers has no net effect on reconciliation. You are right that there is a structural issue to do with the devolution of income tax, but, as I have said, that is not an issue for the commission.

Dame Susan Rice: I will add a footnote. As Alasdair Smith has said, the reconciliation numbers are likely to go up and down and will certainly vary from year to year. The budget is real, but it is based on forecast numbers that will evolve, so, as I said in my opening remarks, the Government will need to think about how to manage its budgets at home and allow for variability over time to ensure that it can pay benefits in real time and make expenditure. That is another challenge.

The Convener: I recognise that I have dominated a fair bit of the discussion; I would like to go further, but I must be fair to others and let them in.

Adam Tomkins (Glasgow) (Con): I will ask two sets of follow-up questions on the area that the convener has explored. I will ask first about earnings and secondly about borrowing and something that Professor Smith said.

When the commission was previously before the committee, five months ago, Alexander Burnett and others quizzed it heavily on the eye-catching increase that it projected in additional-rate and higher-rate taxpayers in Scotland, which the commission said would lead to significantly increased income tax revenues accruing to the Scottish Government in the forecast period from now to five years ahead. Do you stand by those forecasts? They surprised a number of us when you previously appeared, and you now tell us that the opposite is the case—that income tax revenues in Scotland are unlikely to increase as quickly as previously forecast, because of a differential in the income distribution between Scotland and the rest of the UK.

John Ireland: To go back to what you said at the start, in our December report, we said that we had on the basis of the outturn data adjusted our view of where people sat in the distribution and we said that the number of higher-rate taxpayers had increased. I think that we also said that, because of where they were positioned in the distribution—they were positioned very near to the threshold—that would not lead to such a proportionate and dramatic increase in income tax revenue. The paradox that we tried to explain the last time we appeared before the committee was a dramatic increase over time in the number of higher-rate taxpayers but income tax revenues not increasing by so much.

10:30

Adam Tomkins: I understand that, but do you stand by those forecasts? Is it still the Scottish Fiscal Commission's view that the number of additional-rate and higher-rate income tax payers in Scotland is likely to grow dramatically, as you have just said, over the forecast period?

John Ireland: We have published the numbers of higher-rate taxpayers—we did not put them in our summary report, but we publish them on the web—and those numbers are consistent with the numbers that we used in December.

Adam Tomkins: So you stand by the forecasts.

John Ireland: We stand by those forecasts.

Adam Tomkins: Will you remind the committee what those forecasts were based on? Forgive me, but a number of us have a degree of scepticism about the extent to which those numbers can be trusted.

John Ireland: On how the income tax forecast is constructed, we have a sample survey of individual tax records throughout the UK with geographical identifiers—we can therefore identify Scottish taxpayers. That is a large sample of the administrative data. With that sample, we took the outturn data that we had for 2016-17, which gave us the number of taxpayers in each band, and we adjusted the number of those tax records so that they reflected exactly the distribution that we saw in the outturn data. In other words, we can be confident that we reflect the outturn data, which is the best data that we have, in the micro data that we use to do our forecasts. We then apply the growth rates from our macroeconomic forecasts to the individual tax records. We can then see where people lie over time in the income tax distribution—where they are distributed between tax bands. That is a purely mechanical thing.

That, in essence, is how the forecasts are generated. This time round, we had another sample of the administrative records taken, so we have another year's worth of data. Again, we adjusted that so that it reflects exactly the outturn data that we have for 2016-17. In a sense, that is why we stand by the forecasts.

There have been some changes in the new data, but the impact has not been dramatic. What has caused the difference in our income tax forecasts this time round is the improvement in our macroeconomic forecast. Earnings are currently doing particularly well, and that feeds through into our macroeconomic forecast. That has generated the new income tax forecasts.

I hasten to add that the growth in the income tax forecast this time round is not as dramatic as members might take from the earnings, because we have made an adjustment to account for some UK policies. We have better information from the OBR on how UK policies have affected Scottish taxpayers. In effect, the adjustment for pension auto-enrolment cancels out most of the increase in the income tax forecast. Therefore, there have been two net movements.

Adam Tomkins: Thank you. I appreciate that. It is helpful to get all that on the record.

My second set of questions will follow up on what the convener asked about. Professor Smith, I think that you said in answer to one of the convener's questions that the Scottish Government has to be ready to deal with this scale of adjustment. Have I written that down right? We are talking about an income tax reconciliation adjustment of £1 billion over three fiscal years, which you said is not out of kilter with the ordinary business of comparative forecast inaccuracy, and your key point is that the Scottish Government needs to manage the nation's finances such that it is ready to deal with this scale of adjustment and that it will be a normal feature of fiscal events and financial planning in Scotland under the current fiscal framework. Given that paragraphs 3.67 and 3.68 of the report that was published last week say that the Scottish Government will not be able to deal with this level of adjustment through the use of its borrowing powers because, to use the colloquial, so much of the credit card has already been maxed out, does that suggest that the current stewardship of the nation's finances has not been sufficiently prudent to deal with this ordinary, usual and routine scale of adjustment?

Professor Smith: I confirm what I said earlier: this scale of reconciliation is of a general order of magnitude that should not be surprising and that the Scottish Government will need to plan for. I hope that, sometimes, it will be positive rather than negative.

The Government's scope for dealing with these adjustments without having to cut spending or raise taxes comes from its drawing on the Scotland reserve up to a maximum of £250 million a year, and drawing on resource borrowing up to, I think, £300 million a year. It is not so much that we are maxing out the credit card as it is that credit cards have annual limits. However much money is in the Scotland reserve, if only £250 million can be drawn down in any one year, that is the annual limit. If, in a year's time, we face an adjustment of £600 million—at the moment, that figure is just an estimate—simple arithmetic shows that adding £250 million and £300 million does not add up to £600.

Adam Tomkins: Yes—even I get that.

Professor Smith: Therefore, Dame Susan said that, if things turn out that way, the Government will need to look at adjusting expenditure or raising revenue to deal with the situation.

Adam Tomkins: The Government will not need to look at that—it will have to do that. That is what you say—quite graphically—at paragraph 3.68 of your report:

"this will mean the Scottish Government having to adjust its spending plans or increase taxes".

Those are your words. What do you mean by that?

John Ireland: I will add to what Alasdair Smith said and respond to something that you have said. There are two sorts of borrowing: resource and capital borrowing. The Government is using its capital borrowing and it will max out if it continues in the way that it is going. It has yet to use its resource borrowing powers. Resource borrowing can be used to deal with reconciliations. The Government has £300 million that it can use—there is £300 million on the credit card, as Alasdair Smith would say—to deal with reconciliations each year. The issue is that it has to repay that borrowing over three to five years, so a big credit card bill cannot be run up.

Alasdair Smith said that the Government can use £250 million from the reserves. That is true. However, those are resource reserves and, at the moment, there is only about £146 million in the kitty. To modify a little what Alasdair said, the position is perhaps more optimistic on borrowing than you might have thought and slightly less optimistic on the reserves, because there is only £146 million in reserves.

Adam Tomkins: That is very helpful but, to underscore the point, you say in paragraph 3.67 of your report that those figures combined will not be

"sufficient to manage the ... income tax"

reconciliations that you are currently forecasting. In paragraph 3.68, you continue:

"this will mean the Scottish Government having to adjust its spending plans or increase taxes".

Is that right?

Professor Smith: Yes, except that I think that we say "would"—the reconciliations that are in our report are still forecasts. If we end up with reconciliations of £250 million, £249 million and £608 million, the "would" would become a "will". We have spelled that out in our report, and I do not think that there is anything to add to the words in our report.

Tom Arthur (Renfrewshire South) (SNP): Good morning, commissioners. The reality is that there are two credit cards: there is a capital credit card, which has been used; and there is also a resource credit card, which the Government has not used at all—the Government has not even taken a ballpoint pen and signed the back of it. Therefore, the resource capacity is still there to be used. Is that right?

John Ireland: The resource capacity is there to be used. The Government has not used all the capital, but it is using it at a quick rate.

Tom Arthur: An element of that is up to £600 million a year, with £500 million for in-cash management. That would be deployed to manage demand-driven expenditure, such as social security. Is that correct?

John Ireland: Sorry?

Tom Arthur: I am asking about the £500 million a year for in-cash management that is available in the resource capacity for borrowing. That would be used to meet demand-driven spending, such as that required by social security. The reason I why ask that question is that you make forecasts on social security, and there is an expectation that, next year, £3.5 billion will be required for that. Is that correct?

John Ireland: Yes. Because the social security budget will increase, and it is demand led, there will be a need for in-year cash management, and there are facilities to allow that.

Tom Arthur: Can you clarify your confidence in the forecast of £3.5 billion for next year? I appreciate that it is difficult, as the powers are only just now coming online.

John Ireland: It is important to be clear about what that forecast represents. It represents our forecast of the social security benefits that Scotland will have the executive authority for. In other words, the DWP will administer them on DWP rules—they will not be dealt with on Scottish rules. It is a broad-brush first attempt to forecast what the bill will be, on continuing United Kingdom rules. If there are changes in eligibility or in how the benefits are administered as they are taken over by Social Security Scotland, the forecast will change. We have not taken account of that.

Tom Arthur: What I am trying to get is a sense of how confident you are about the figure. Given that, for the best start grant, there was a forecast of 4,000 applicants for the full year, but, in reality, there were 4,000 applicants on the first day, I am trying to understand how confident the commission is in its forecast, so that I can understand whether the in-year cash management and resource borrowing powers are sufficient. How confident are you about that £3.5 billion figure? Obviously, we have seen significant forecast reconciliations over income tax, and I am keen to get a sense of the potential error around social security forecasting.

John Ireland: We would not put any quantitative error bands around that. As I said, this is an initial forecast based on UK rules. Forecasting is difficult in relation to new social security benefits, as has been shown in relation to the first one that came along. I would expect there to be some significant forecast error there, but I could not say which way. It is a pretty uncertain forecast—that is how I would put it.

Tom Arthur: Can you quantify "significant" as a potential percentage?

Professor Smith: I do not think that we are in a position to do that. In our report, we highlight the fact that a social security budget of £3.5 million—

Tom Arthur: Billion.

Professor Smith: Yes, billion. We say that, given that there is a possibility of eligibility changes coming into that as social security gets fully devolved, that sum of money is one that comes with a high degree of risk. We draw attention in our report to the fact that there is a significant fiscal risk. We agree with you on that point, but putting numbers on that risk is harder to do.

Tom Arthur: Is it possible?

John Ireland: I am not going to do it just now on the back of an envelope or on a pocket calculator, but what you could do is look at the OBR's record of forecasting social security benefits and find out the sort of average error that the OBR has made and then apply that to our £3.5 billion forecast. That would give you a ballpark figure but, as I say, I am not going to do that this morning.

Tom Arthur: Okay, I will not push any further on that.

I appreciate that income tax forecasting is an art, not a science, and that we are still in the early days of the new process, but what are your expectations of forecast errors in the future? I appreciate that there are two parties involved at the moment—you and the OBR—but I would like to know what you think the possibility is of further reconciliations in the region of £600 million being required. Is that something that we should become accustomed to and expect, or should we expect that, as the years progress and more information and data become available, we will see far smaller margins of error?

John Ireland: We have had a look at the OBR's track record on forecasting income tax. Susan Rice mentioned earlier that its average absolute error is about 3.3 per cent, so you can expect a margin of error of that sort of magnitude, which comes to roughly £500 million.

We also saw that, in the OBR's track record, there is a pattern of consistent errors—you get a positive error followed by a positive error and another positive error, and then it might flip. You would expect the errors on average to be zero, because forecasters do not make systematic errors but make errors that are then corrected. However, what we observed in the OBR's forecasting record is that errors of the same type persist over time. We are forecasting three negative reconciliations. I will not promise, but I hope that at some point that will flip the other way round.

10:45

Professor Smith: To add to the complications of what John Ireland said, as we have explained, the reconciliations arise not from one set of forecast errors but from two, which complicates the issue further. It is not about what sort of forecast errors we might reasonably expect from the Scottish Fiscal Commission or the OBR, but how often we will err in the same direction, so that there will not be a reconciliation problem, and how often we do so in different directions, so that our two errors, put together, will create a bigger reconciliation rather than a smaller one.

Dame Susan Rice: Without wanting to muddy the waters or the thought process, there will be other reconciliations. It is not just about income tax; over time we will see reconciliations in relation to social security and some devolved taxes. It is a very complicated landscape.

Tom Arthur: I appreciate that it can go either way and that, in the long run, the reconciliations should cancel each other out, but £550 million is not an unrealistic number.

John Ireland: I will answer the question in a different way. When we saw that it was £500 million to £600 million, we were not surprised.

Tom Arthur: My final point is that the theoretical maximum that the Scottish Government would have to address that is £550 million; that takes £300 million of resource and £250 million of reserve. However, that is contingent on having enough reserve, and the resource is also contingent on a £600 million cap, within which

£500 million can be spent on in-year cash management. Therefore, if money is used to address social security forecast errors in year, my understanding is that that would reduce the amount of money from resource borrowing that is available to address income tax forecast errors. The potential of even having £550 million is limited.

That was the reason for my line of questioning. I appreciate that you cannot comment on the applicability of that to the fiscal framework, but it raises a lot of questions about going into the fiscal framework review. When £550 million of forecast error is not abnormal or unusual, the means available to the Scottish Government meet the situation are exceeded.

John Ireland: We cannot comment on the fiscal framework—it is not our job—so we took the approach that Mr Mackay took in his statement and asked, "Here are the rules—what are the implications?" The implications are that, if the reconciliations turn out as they may, there will be a need to adjust the spending or for more taxes.

Professor Smith: Just as a matter of fact, we can agree with you that the Scottish Government's borrowing powers, as set out in our report, are relatively modest when set against the scale of possible reconciliation. That is a fair observation.

Tom Arthur: That is independent of policy and Government decisions and based on the amount of information that can be provided through forecasting. Those borrowing powers are not necessarily enough to meet forecast error. Is that a fair statement of fact?

Professor Smith: I will stick with the statement of fact that I gave you, rather than trying to elaborate.

Patrick Harvie (Glasgow) (Green): I apologise for sticking with that area for a bit longer. The scale of the numbers that we talked about has been described as "normal", but a normal Government would face uncertainty from one set of income tax forecasts, rather than two that are conducted separately, perhaps under separate methodologies that potentially compound each other. "Normal" is perhaps a questionable word to use.

On the scale of the reconciliation in the 2018-19 tax year, which is the biggest element of the figures, we would not expect you to comment on the policy choices that a Scottish Government would face if the £600 million plus that we are talking about is the figure. However, Susan Rice still described that as "an estimate". To what extent is the projection based on actual tax data for 2018-19, as opposed to still being an estimate, and, if it is still an estimate, when will we know the final figure?

You will appreciate that, although it is not for you to comment, it is for us to consider, because of the huge political implications of a reconciliation of this scale on a budget that is being voted on in this Parliament two months before a Scottish general election.

John Ireland: The simple, straightforward answer is that you will not know the outturn figures for 2018-19 this July, but you will do next July. However, the information that we get from the numbers that we will see this July will help us to refine the estimates. The real-time information that HMRC collects on pay-as-you-earn receipts at Scottish level will also feed into our forecasts. Therefore, there is already some real data in our forecasts. Over time, the forecasts will improve, and the next big improvement will be in July, when we get the next set of outturn data. However, you will not see the outturn data for 2018-19 until July 2020.

Patrick Harvie: Are you narrowing the uncertainty by using the data that you are working on at the moment, or should we still consider the figure as a forecast?

John Ireland: It is definitely a forecast. As we get more data, such as the real-time information, the outturn data and the sample of administrative records, which we got a couple of months ago, the data element of the forecast will increase and the forecasting element will reduce. It is a gradual process; it is not black and white. We are certainly getting more information and hard data, which will go into the forecast over time.

Dame Susan Rice: As far as we know, there will always be the 15-month lag between the end of the fiscal year and the publication of the income tax outturn data.

Patrick Harvie: The hard number will finally be known in the middle of the summer recess, a couple of months before the Scottish Government has to publish a budget for 2021-22.

John Ireland: Yes.

Patrick Harvie: Thank you.

The Convener: On that cheery note, I will let James Kelly in.

James Kelly (Glasgow) (Lab): What is making the committee nervous is the way in which the forecasts are changing and the fact that this set of forecasts paints a bleaker position than was painted by previous forecasts. I will take one year, so that I can try to understand how the numbers for that year have moved. For this budget year—2019-20—on the basis of the latest forecasts, we will potentially be £188 million worse off than we thought we would be when the budget was set. That is because, although the commission's forecast for the Scottish Government's tax revenues has increased by £20 million, that increase has been offset by the OBR's forecast for the block grant adjustment, which is that it is set to increase by £208 million.

I am interested in those movements. What drove the £20 million increase in the forecast for the Scottish Government's income tax revenues from the position earlier in the year?

John Ireland: I think that you are looking at table 4.4, which gives the change in our income tax forecast. As I said in my response to Adam Tomkins's question, the improvement in earnings caused us to increase our forecast for 2019-20 by £150 million, but that increase was offset by the big negative of £127 million, which we came up with after receiving more information on UK policies and their effect on Scotland. After talking to the OBR and HMRC, which are responsible for estimating the effect of UK policies, we took £127 million off our forecast to reflect how pension auto-enrolment had been working. Other UK policy changes added £10 million to the forecast. We also had the new micro data, as I mentioned earlier, which knocked £30 million off the forecast. The forecast's overall increase by £20 million was driven primarily by an improvement in our economic performance, which drove the forecast up, and by our taking better account of UK policy in Scotland, which led to a reduction.

James Kelly: When the budget was set, it was known that pension auto-enrolment would come into play. What information came to light that resulted in the reduction being factored in?

John Ireland: When the policy is first set, the OBR publishes a set of policy costings. The problem is that, when a policy costing changes, that is not reflected in the publication, because it is never revised. It is, therefore, very hard for us to track exactly how HMRC costings for the OBR change. We rely on conversations with the OBR.

The conversations that we had before Christmas indicated that some change was happening, and we tried to take account of that, but the subsequent conversations after Christmas made it clear that the costing was changing again, so we needed to change ours, too. Basically, as we spoke to the OBR, we got more insight into how HMRC costings for the UK were changing and we took those on board. As soon as we had the information, we included it in our forecasts.

That is how it works: we change our forecasts a great deal to reflect UK policy. It just happens that that was a particularly big change, but the process is the same. We take the public information, initially, and we then have conversations with the OBR, which tells us how things have moved.

James Kelly: What was the basis for the £208 million increase in the OBR's forecast of the block grant adjustment?

John Ireland: That was a very different issue, which we talked about at the start of the meeting. When the OBR made its original forecast, it set a low growth rate for UK tax revenue, but, as it saw how UK tax rates were increasing over time—due, in part, to the higher earners in the rest of the UK—it revised the growth rate upwards. The movement in the block grant adjustment came through a year or so ago. It was a much bigger adjustment and was not related to the policy costings at all.

James Kelly: But the figure of £208 million is a change from when the budget was set. What new information has come to light for the OBR to have changed its forecast in such a short time?

Professor Smith: As John Ireland says, it is just the continuation of what we have seen already with UK tax revenues, which have been surprisingly buoyant—and the surprises are still coming. That adjustment of £208 million reflects continued growth in UK tax revenue, which is probably, as we said earlier, concentrated at the top end of the taxpayer distribution.

The Convener: I want to bottom some of that out. We are agreed that there is a structural issue, and it is now clear, from your evidence, that there is a risk that the UK tax base is growing more strongly than the Scottish tax base. It did for 2017-18 and 2018-19, and that trend may be likely to continue. If that is the case, what are the main drivers of that difference?

Professor Smith: It is worth emphasising that all those tax adjustments start with a base in 2016-17, with income tax devolution. The block grant adjustment for 2016-17 was set equal to Scottish income tax revenue, and, when we had the outturn for 2016-17, that was adjusted for the fact that there were fewer higher-rate taxpayers proportionate to the rest of the UK. In the past two years, we have apparently seen that income growth has been stronger at the top end of the distribution. We do not know whether that is a permanent feature of the economy; it has happened over the past two years, but it might well be reversed—there is no law. It seems to be a feature of the structure of the Scottish economy that Scotland has fewer higher-rate taxpayers.

11:00

The Convener: Why is that?

Professor Smith: I am talking not simply about people who are only just in the higher tax bands, but about the highest-paying taxpayers. Why have the incomes of chief executives, of commercial lawyers and of partners in international accountancy firms been rising faster over the past two years than the incomes of everyone else? That is a big question, and we could spend hours speculating on it. The important thing is that there is no reason to suppose that the phenomenon will continue.

Dame Susan Rice: In the past, we have mentioned two things that underpin the differences in income growth and income tax: the working-age population in Scotland is not growing at the same rate as we see in the rest of the UK, and the overall population is not growing to the same extent. Those things might have smaller effects, but they affect how much income is being drawn in, because our income tax is based on actual earnings income in Scotland. Those demographic features are important as well.

The Convener: I understand that, and Alexander Burnett will ask some questions on that issue soon. However, Willie Coffey still has a question on the area that we are talking about.

If we do not know whether the issue around salaries at the higher levels is going to continue into the future, we had better find out, otherwise it could have a dramatic effect on the difference between the UK economy and the Scottish economy for some time.

Willie Coffey (Kilmarnock and Irvine Valley) (SNP): My question is about forecasting in general. Can you clarify for my simple mind something that has already been said? I think that you said that the biggest factor that might affect the Scottish budget is not the performance of the Scottish economy or Scotland's performance on tax relative to the rest of the UK but the "comparative forecast accuracy"—I think that those are the words that John Ireland used. Is that the main factor that leads to these reconciliation figures?

Professor Smith: No. If it was me who said that, it is not quite what I meant to say. The reconciliation problems come about because of the two forecasts being out of line in a different way. I agree with the convener that, if the underlying issue is income growing at different rates in different parts of the distribution, once the forecasters get a grip on that, it will be built into the forecast and will stop showing up as a reconciliation issue. However, that will not mean that the issue has gone away; it will then be built into our forecasts.

If, for structural reasons, Scottish income tax revenue is going to grow more slowly than UK income tax revenue, that is a problem for the Scottish budget. At the moment, it is showing up as reconciliations because the forecasters did not anticipate it. Once we start anticipating it, it will be built into the budget and the forecasts. That does not mean that it will go away; it will just pop up in the budget instead of in reconciliations.

Willie Coffey: It was actually John Ireland who used that phrase. I have written it down because I wanted to ask him about it specifically. Given what you have just said, Professor Smith, if the UK has a relatively better performance on tax revenues, the Scottish budget will get hammered.

Professor Smith: That is how the block grant adjustment works.

Willie Coffey: No matter what Scotland's economic performance is, if it is outpaced by the economic performance of the rest of the UK, our budget takes a hammering.

Professor Smith: That is how the fiscal framework works. The block grant adjustment looks at the growth of UK tax revenue and the growth of Scottish income tax after 2016-17. If UK income tax revenue grows faster than Scottish income tax revenue, that is a problem for the Scottish Government. That is what devolution is about. Devolution means that Scottish income tax revenue depends on the performance of the Scottish economy, not on Scotland getting a share of UK income tax revenue.

The Convener: It is more than that. It is about a competition between the rest of the UK and Scotland, not just about how the Scottish economy is doing. That is the fundamental problem. That was a statement, and, because it was a political point, Professor Smith is not responding to it.

Dame Susan Rice: None of us rose to it.

Adam Tomkins: Discuss.

Willie Coffey: That leads me to the black art of forecasting. It might be fair to say that the Scottish Fiscal Commission is on the pessimistic side of the forecasting business. I do not want to start a spat with Professor Tony Mackay, whose paper I am sure you have read. He says that your estimates are always on the pessimistic side. For example, he has looked at the gross domestic product forecast and says that, since December, you have downgraded your GDP forecast by a third. In December, the forecast was 1.2 per cent, and now it is 0.8 per cent. What is responsible for that marked downgrading in the GDP forecast? How reliable are your estimates? Going forward, can we have any confidence that they are accurate?

John Ireland: There are a number of issues around what Professor Mackay says, and I will lay out a couple of them. First, we made four forecasts. That is not a lot of forecasts, and it is not as many as Professor Mackay has made. We do not yet have much outturn data. We also know that, particularly with national accounts, things can be revised for some time.

It is fair to say that the jury on our forecasting record is still out. Every year, in September, we look at our forecasting record. Last September, we produced a comprehensive account of how our forecasts were not in line with the outturn data as we thought it was at that time, and we will do the same in September this year. We take forecast evaluation seriously, but we have not made enough forecasts or had enough real data back yet to judge whether we are pessimistic or optimistic or to judge our forecasting record.

Turning to the forecast that we have just made and the matter of pessimism, it is probably useful to note that PricewaterhouseCoopers and the Fraser of Allander institute have also revised down their forecast for 2019—both by 0.3 percentage points. Everyone is revising their forecasts down.

Willie Coffey: However, the Scottish Fiscal Commission's forecast is always much lower.

John Ireland: You asked why our forecasts have been revised down. I shall now give you an explanation.

The Scottish economy has been particularly strong over the past two years. In the main, that has been driven by a strong net trade performance, which, in part, has been driven by the depreciation of sterling. We have had two good years of the Scottish economy operating above capacity, but the economy cannot operate above capacity for ever. Therefore, we anticipate that the growth rate will come down.

Since the OBR issued its forecast, about three months ago, Brexit has moved on—there is a lot more uncertainty about Brexit than there was—and we have more data on business investments: that area is looking weaker. We also know that consumption is relatively soft and that Brexit uncertainty will have a strong impact on it over the next couple of years.

The other matter is net trade. As I said, the strong economic performance over the past two years has been down to, in particular, a strong net trade performance; however, it looks as though the prospects for net trade over the next two years are much weaker. In part, that is because of Brexit; in part, it is because of the world economy. The big international forecasting organisations are forecasting that the world economy will be weaker. The International Monetary Fund produced a forecast yesterday, and the OECD and World Bank forecasts show similar things. The world economy is less strong, and the US is embarking on trade wars with China and, potentially, the EU. The prospects for the world economy are not as good as they were, and the weakness of sterling is now built in.

The reasons for our downward revision are Brexit and net trade.

The Convener: Angela Constance wants to come in on Brexit. However, I said that I would let Alexander Burnett in next. I have done that twice, so I had better let him in at this stage.

Alexander Burnett (Aberdeenshire West) (Con): Thank you, convener.

We all understand that the forecasts have not made for pretty reading. There has been a lot of casting around for causes, with a number of people pointing at population and, more specifically, Brexit. Population is obviously a combination of birth rates, mortality rates, people leaving and inward migration. Net UK inward migration numbers remain steady, although EU nationals are being replaced by non-EU nationals. Even if we stayed in the EU single market, would that completely close the growth gap between the UK and Scotland?

Dame Susan Rice: Professor Smith is the expert.

Professor Smith: I am not sure that anyone is an expert in population issues.

The sensitivity of population and migration to Brexit issues is a key element, because a lot of the difference between the Scottish and UK economies arises from the fact that the Scottish population—especially the Scottish working-age population—is growing relatively slowly compared with that of the rest of the UK. Inevitability, that is a big uncertainty, and it is one of the main channels through which we expect Brexit—however it turns out—to affect the economy. If the Brexit outcome makes migration into Scotland relatively unattractive or difficult, it will have significant economic impacts.

Alexander Burnett: You are saying that the solution is to increase our population through inward migration, but would that not further damage our productivity numbers, for which slow growth is already forecast? Is not the real issue simply that we are not creating the right skills base here, at home?

Professor Smith: Obviously, creating the right skills base at home is a good thing, and it is something that any economy wants to keep its eye on. However, generally speaking, inward migration from the rest of the EU has been positive for productivity and for the skills base, because we, in Scotland—and in the UK in general—have benefited from the inward migration of a relatively skilled labour force. Obviously, that is not to say that we do not need to worry about the skills of native Scots—of course, we do.

Alexander Burnett: Recently, we have heard politicians say that we should attract highly skilled workers—specifically general practitioners—from around the world. Are you aware of any countries that have a surplus of such people to satisfy our failings in creating those skills here?

Professor Smith: That is an element of speculation that takes us too far outside the scope of the Fiscal Commission.

Angela Constance (Almond Valley) (SNP): Dame Susan Rice said in her opening remarks that the Fiscal Commission's Brexit assumptions were "a reasonable basis" for the commission's forecasts. Why does the panel consider the Brexit assumptions to be reasonable?

Dame Susan Rice: I will turn again to Professor Alasdair Smith, who has a particular focus on these matters. However, in general, we consider a number of different factors—it is not a binary this or that. We start with the base that there will be some sort of orderly exit from Europe. We do not have evidence at this point to say that there will not be an orderly exit. However, we consider a number of different factors that draw out of that orderly exit. It is not just A or B—there are a number of different implications.

Even with the uncertainty that we have—and uncertainty has certainly increased—we feel that the starting point in our forecasts is still the right one at this point in time, or at the point in time when the forecast was completed.

Angela Constance: So—

Dame Susan Rice: Alasdair Smith may have more detail

Professor Smith: Carry on, Ms Constance, if you have a supplementary.

Angela Constance: I do, but I would like to hear why you think that the Brexit assumptions are reasonable, as Dame Susan Rice said.

11:15

Professor Smith: Our previous forecast was based on the assumption that there would be an orderly exit in March of this year. That was a reasonable assumption at the time. It was what the UK Government was aiming for and, by and large, what was expected. However, it did not happen.

Anybody looking at the UK scene now would say that the probability of an orderly exit has gone down, because there are now a number of politicians vying for an important position in the UK Government who seem to be willing to contemplate a no-deal Brexit. I think that any reasonable person would say that the probability of a no-deal Brexit has gone up. However, our judgment would still be that that is not the likeliest outcome. There is not a majority for a no-deal Brexit in the UK Parliament. Our central assumption remains that there will be an orderly exit at some point.

As Susan Rice said, it is a broad-brush estimate. If the outturn is different—for example, if a further extension is granted by the EU or there is a decision to hold a further referendum on Brexit—that will have economic consequences that will fit within our broad-brush assumptions. As she said, the one outcome that would not fit within our broad-brush assumptions is a no-deal Brexit. It would have substantial economic consequences that are not in our forecast, so it is a substantial risk to our forecast.

However, we still think that the range of outcomes that are compatible with our forecast, which I have just outlined, are, taken together, more likely than a no-deal Brexit.

Angela Constance: Okay. You said that the probability of an orderly Brexit has decreased and the risk of a no-deal Brexit has increased, and that a no-deal Brexit is a risk to your forecasts. In paragraph 39 of your summary report, you say,

"our forecasts are robust to a range of possibilities",

but what is in your report is based on one scenario. There does not appear to be a consensus in the Westminster Parliament for anything, so it is difficult to point to hard-and-fast evidence. I would be interested to know what work the Fiscal Commission has done on various possibilities and scenarios regarding Brexit.

Professor Smith: As I said, we think that the assumptions in our scenario are broad brush enough that they will be appropriate for any of the outcomes that are not a no-deal Brexit. If you were to ask us, for example, what the consequences would be of a further delay or of a second referendum, whose outcome would be unknown for a bit of time, we would say that they are sufficiently similar to the situation that we are in such that, at our level of macroeconomic forecasting, they would not make a substantial difference to us. So, we have been content with the broad-brush approach that is built into our current forecast.

A couple of months ago, we had to think seriously about whether a no-deal Brexit should be our central assumption. We decided—rightly, I think, given how it has turned out so far—that that would not be an appropriate assumption to make at the time. We have thought about the issues that would go into a different forecast, if we had to make one based on a no-deal Brexit. There would be different assumptions about business investment and migration, and there would be assumptions about the economic effects in those sectors of the Scottish economy likely to be severely affected, such as agriculture, where the sectoral effects would be big enough to have an effect on the overall forecast.

We have done some preliminary thinking about what issues would go into an alternative scenario, but we did not and we do not produce alternative forecasts. If the situation changes and there is a new fiscal event that means that we have to produce a new forecast based on a no-deal Brexit, we have done preliminary thinking about how we would go about doing that.

Dame Susan Rice: A number of factors go into our thinking on Brexit—Alasdair Smith has just mentioned a couple—including productivity, foreign direct investment, trade, migration and currency. We look at those factors. In a few cases, we have done sensitivity analysis, factor by factor. That provides a little bit of background and is something for people to chew over, but we do not produce alternative scenarios or forecasts for such situations.

Angela Constance: I understand what you said about another set of work that is broad brush and based on a non no-deal scenario, but you do not need to be much of a political scientist, economist or professor to look around and see that the political situation is fluid. I am not asking you to comment on the political situation, but what work on a no-deal scenario—or, indeed, on other permutations—are you in a position to share, bearing in mind John Ireland's earlier articulation of the impacts on business investment, trade, migration and productivity?

Professor Smith: As Susan Rice said, it is not our job to produce alternative scenarios—we base our forecasts on what seems to us to be the appropriate scenario in any given forecast. We do not have a no-deal Brexit scenario forecast hidden away. However, as I said, we have done quite a bit of serious thinking about what would go into such a forecast, and the effects on migration, investment and particular sectors of the Scottish economy would be among the key features.

It is worth considering that, if we get into a no-deal scenario, UK fiscal and monetary policy would probably be adjusted quickly, in order to address the consequences of that situation. The UK Government would be looking at whether there were appropriate fiscal changes and the Bank of England would be looking at monetary policy. It would not even be sensible for us to jump in. We only produce forecasts when we require to for fiscal events. In any case, it would be sensible to wait until we were clear what the fiscal and monetary framework was in which our no-deal scenario forecast was to be done.

Angela Constance: So we might be waiting a while for some clarity.

Paragraph 37 of your summary report says that although there was a period of nearly two years of "sustained above average growth", nonetheless you have had to revise your outlook down because of Brexit. This is what your report says:

> "All else equal, this nearly two year period of sustained above average growth might have led us to revise up our outlook for the economy. However ... we expect the ongoing uncertainty created by the Brexit negotiation process will limit growth."

If it was not for Brexit, what would your forecast have been for growth in Scotland?

Professor Smith: You are inviting me to describe an alternative scenario that we have not produced—

Angela Constance: I thought that forecasting was your normal business.

Professor Smith: We do not produce such scenarios. For the reasons that John Ireland explained earlier, Brexit uncertainty is one of the factors that have led us to downgrade the economic forecast, in spite of relatively strong performance over the past two years, but it is by no means the only factor. The most significant Brexit effect is an assumption that Brexit will have a negative effect on investment growth.

However, as John Ireland said, the single biggest effect that is bringing down the forecast rate of economic growth is the assumption that the depreciation of sterling, which has driven strong trade performance for the past two years, has now happened and is baked in. We cannot expect continued strong trade performance improvement, and that has a bigger impact on bringing down our GDP forecast from 1.3 per cent to 0.8 per cent than the Brexit effect. The words about Brexit that you quoted concern part of the negative effect in our relatively subdued forecast, but it is not the whole story.

Angela Constance: Thanks.

The Convener: There are a couple of supplementaries on the Brexit question before we move on to the public sector.

Emma Harper (South Scotland) (SNP): Picking up on what Angela Constance said, I want to ask about forecasting based on tighter immigration policies that might be set by the UK. We are already seeing a reduction in the number of nurses and midwives who are registering with the Nursing and Midwifery Council, and there has been an increase in the number of people leaving—4,000 people have left, which is an increase of 29 per cent. We know the impact on agriculture if we have a tighter immigration regime, whether it is seasonal workers such as fruit pickers or the all-year-round dairy workforce. I am curious as to why there is no succinct forecast about the specific impact on Scotland of a tighter immigration regime.

Professor Smith: Our current forecast assumes that there will be less migration than we have seen in the past. Some reduction in migration is built into the forecast, because we can already see that in the numbers. As you say, those are not just numbers; we see the effects in particular sectors that have a lot of migrant workers, such as the health service, health and social care and agriculture. The big effect on migration would come if we were looking at a no-deal Brexit scenario, when the sectoral effects would be so big that we would be thinking about how they would feed through to the macroeconomic forecast. At the moment, some reductions in migration are built into our forecast and we think that that is at an appropriate level.

John Ireland: Earlier, Dame Susan said that we produce a sensitivity analysis of our forecast. In table 2.7 of the report, there is a set of variants around different migration assumptions. If you want to build your own forecast you can have a look at table 2.7, which gives you a sense of the impact on GDP, employment and average earnings of high and low variants of migration.

The Convener: Murdo Fraser also has a supplementary in this area.

Murdo Fraser (Mid Scotland and Fife) (Con): Thank you, convener. First, I apologise to the commissioners: I was at another committee meeting moving amendments to the Transport (Scotland) Bill, so I missed the earlier part of your evidence.

I have a follow-up to Angela Constance's questions on Brexit. I absolutely understand everything that you said about not providing alternative scenarios, but I will have a go anyway. Let us assume, hypothetically, that Brexit gets called off and we are staying in the EU and the single market. In that event, would you expect Scottish economic growth over the next three or four years to match UK economic growth, or is there more to it than that?

11:30

Professor Smith: Thank you for the warning that you were going to ask a question that would tempt us to talk outside our brief. The honest answer is that we do not know. It is not something that we have thought about.

To go back to my response to Ms Constance, Brexit being cancelled is not so far away from our broad-brush orderly Brexit scenario that we would regard it as having dramatic effects, especially in the short term. There would be uncertainty effects associated with Brexit being cancelled that might well have a negative economic impact. However, the relative performance of Scotland and the rest of the UK in a no-Brexit scenario is hard to speculate about, even if it was our business to do so.

The Convener: Good try, thank you.

Murdo Fraser: Thank you.

The Convener: Emma Harper has another question.

Emma Harper: Yes—it might even be a good-news question. I am interested in public sector pay. We have heard about higher-rate taxpayers this morning, but we know that public sector pay has been increasing in Scotland and most, if not all, of us would like to see earnings continue to increase across the public and private sectors. What would you expect to be the return in tax revenue for every additional pound in earnings?

John Ireland: We do not construct that sort of ready reckoner. I can say that the Government's public sector pay policy is built into our forecasts. As you said, the generosity of that pay has increased over time, and that is reflected in our forecasts. We do not build the sort of ready reckoner that would show that if public sector pay was increased, you would get a pound or 50p more in income tax; that is not our job.

Emma Harper: Last week, I asked a question in the chamber about the possible increases in public sector spend as a result of processes that might have been followed after a £1 billion spending decision that Westminster made, and whether a Barnettised approach might have been taken. The response was that Scotland would have had an increase of £3 billion in our spending. That would mean that an extra £750 million would have come to Scotland. Should we have argued for that?

Professor Smith: You have struck us speechless.

Dame Susan Rice: It is hard for us to respond to that. It is your call.

Professor Smith: It is a feature of the devolved system and the Barnett formula that the Scottish block grant responds to spending decisions in the rest of the UK. As Dame Susan said, it is not for us to advocate one thing or another.

Neil Bibby (West Scotland) (Lab): I want to go back to the Brexit issue.

The Convener: Have another go.

Neil Bibby: You said that the biggest effect of uncertainty was on investment. Is the uncertainty affecting investment in Scotland more than in the rest of the UK, or is the effect the same?

Professor Smith: I do not think that it is a Scotland-only effect. The UK as a whole is being affected. I do not know about the Scotland-UK comparison.

John Ireland: I do not know either, but I know that the OBR has marked down its business investment forecast. It is important to say that business investment data in the UK and Scotland is really poor. Although the forecast has shown quite dramatic reductions recently, it is hard to judge relative performance. That is another issue.

Murdo Fraser: I have a question about process. Last week, the finance secretary delivered to Parliament the medium-term financial statement. He reported on a number of aspects of what was in your report. However, he made only tangential reference to a number of aspects, including an issue that has taken up a lot of time this morning; I am talking about income tax reconciliation and the potential £1 billion-plus reduction in the money that is available in public finances. Subsequently, it became clear that that was a major talking point, as it has been this morning.

That information was not made available at that time to Opposition party spokespeople or to other members who were asking questions of the cabinet secretary. Your report was not published until after the meeting of Parliament at which the statement was made. It occurred to me at the time—this might be reflected in the views of other members—that having a partial explanation of the situation from the cabinet secretary did not allow the fullest opportunity for parliamentary scrutiny.

I understand that the release of your data is agreed in the memorandum between the Scottish Government and the Fiscal Commission. I do not expect you to answer immediately, but I wonder whether you might want to go away and reflect on the timing of the release of data to Parliament and whether, in future, it might be helpful if, in advance of such a statement being made, more facts might be made available to Opposition members, particularly when key issues need to be highlighted that are not covered in the finance secretary's statement.

Dame Susan Rice: You are correct in saying that the way in which we interact with the Government is laid out in an agreed and public protocol. We have always been very transparent about that and we follow what is in the protocol. However, protocols can be looked at and reconsidered. Indeed, the first edition of the protocol changed after a year once we had felt our way through it. The changes were not to the factors that you are talking about, but to timings of exchanges.

On behalf of the commission, I could say that we are happy to at least look at it. I am not making promises about changes but we could certainly look at when we lay our report before Parliament, which is what I think you are talking about. We will take that away and consider it.

John Ireland: The protocol is due to be revised this summer. When we did the previous set of revisions, we spoke to Jim Johnston about it and we will have a conversation with him over the summer.

The Convener: I am glad that Murdo Fraser asked that question, because it was not just Opposition members who were affected. We are considering the information that is available to everyone in Parliament so that we can ask proper questions of the cabinet secretary.

I thank our witnesses. It has been an interesting session, and lengthier than those that we have had in the past. A lot of information has been exchanged.

11:37

Meeting continued in private until 12:03.

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