



**OFFICIAL REPORT**  
AITHISG OIFIGEIL

# Finance and Constitution Committee

**Wednesday 2 October 2019**

**Session 5**



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**Wednesday 2 October 2019**

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**FINANCE AND CONSTITUTION COMMITTEE**

**21<sup>st</sup> 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)

\*Angela Constance (Almond Valley) (SNP)

\*Murdo Fraser (Mid Scotland and Fife) (Con)

\*Patrick Harvie (Glasgow) (Green)

\*Gordon MacDonald (Edinburgh Pentlands) (SNP)

\*John Mason (Glasgow Shettleston) (SNP)

\*Alex Rowley (Mid Scotland and Fife) (Lab)

\*attended

**THE FOLLOWING ALSO PARTICIPATED:**

Derek Mackay (Cabinet Secretary for Finance, Economy and Fair Work)

**CLERK TO THE COMMITTEE**

Jim Johnston

**LOCATION**

The David Livingstone Room (CR6)



## Scottish Parliament

### Finance and Constitution Committee

*Wednesday 2 October 2019*

*[The Convener opened the meeting at 10:07]*

### Decision on Taking Business in Private

**The Convener (Bruce Crawford):** Good morning and welcome to the 21st meeting in 2019 of the Finance and Constitution Committee. I remind members to do the usual with their mobile phones.

Agenda item 1 is a decision on taking item 3 in private. Do members agree to do so?

**Members indicated agreement.**

## Fiscal Framework Outturn Report

10:08

**The Convener:** Our next item of business is evidence from the Cabinet Secretary for Finance, Economy and Fair Work on the Scottish Government's fiscal framework outturn report and other issues relating to our pre-budget scrutiny. The cabinet secretary is accompanied by Scottish Government officials Lucy O'Carroll, director of tax, and Daniel Hinze, deputy director of fiscal responsibility.

We will go straight to questions. This session on the fiscal framework outturn report is part of our pre-budget scrutiny. I remind the cabinet secretary that the Auditor General for Scotland, in her report, "The 2018/19 audit of the Scottish Government Consolidated Accounts", said that the

"Scottish Government needs to improve the quality of financial reporting to better support Parliament"

and cited concerns about the content of the medium-term financial strategy. How does the Scottish Government plan to respond to those comments?

**The Cabinet Secretary for Finance, Economy and Fair Work (Derek Mackay):** I understand the concerns. However, we should bear in mind the United Kingdom Government's decision to set a one-year budget and not to have that comprehensive spending review, which made it more difficult for the Scottish Government to do the same.

On the position of the Auditor General, much more information will come through the budget and the spending decisions that we make. I will give further consideration to what the Auditor General said on the future medium-term financial strategy but, considering the levels of volatility, I will be able to set out more in the budget. There is more information on scenarios and on some of the principles that we would deploy in fiscal policy within the MTFs, which sets out a position on capital and other matters. However, of course, I will continue to fully consider the content of the Auditor General's comments.

**Murdo Fraser (Mid Scotland and Fife) (Con):** I have a question on the Barnett consequentials from the UK spending round. The figures that we have suggest that those would amount to £1.1 billion of resource, in addition to £87.8 million in capital that applies to the financial year 2020-21. A number of announcements at the Conservative Party conference over the past few days might well lead to Barnett consequentials; no doubt we will hear more in the coming days. For next year's budget, you are starting at a point where there is a negative reconciliation, due to the shortfall in

income tax receipts, compared with the forecast of £204 million. Your black hole for next year has already been filled in by the Barnett consequentials, and there are substantial additional moneys at your disposal.

Can you give us any flavour of how you might want to spend that extra money? Councils across Scotland are considering their budget position, as they look towards next year, at the same time as there is pressure in health and education. Can you tell the committee your thinking about allocating the money?

**Derek Mackay:** I would not want to prejudice the budget and pre-allocate resources that are apportioned to the next financial year. I know that this is pre-budget scrutiny. I look forward to hearing from the committee, and other committees, its recommendations and views on the budget, so I do not propose to prejudice the presentation or content of the budget. Allocating those consequentials will be part of the usual process.

On the other matters that the member raised, the chancellor has made some spending announcements during his party conference. I look forward to seeing the detail of the profile and Barnett consequentials that might come to Scotland. There is an issue about how that profiling is done, but any Barnett consequentials will be considered as part of the usual budget process. Tax reconciliations are covered in the outturn report for the next financial year. We have the ability to use the drawdown from the reserve and the reserve borrowing powers if we choose to.

I set out some principles in the medium-term financial strategy, but the exact mechanisms that we will use will be set out very clearly in the budget when it is presented.

If the committee wishes, I can talk about the timescale for the budget, as anticipated—there is no clarity from the UK Government on when its autumn budget will be announced. That leaves us not knowing the position on tax and the whole position for the Scottish budget, because in order to have an understanding of the fiscal framework and to fully inform the Scottish budget, we need the tax and block grant adjustment determinations.

My current thinking is to set the Scottish budget in December, as has been the pattern over the last few years; I propose 12 December, but that is on the basis that we will have a UK budget. That would give me the necessary time to inform the Scottish Fiscal Commission, the convener and the Finance and Constitution Committee. This is the first time that the date that I am working to has been shared publicly. I will write to the committee to confirm that date, but we need the UK budget to

help us with the figures that will drive the whole budget process.

I will work to that rhythm of business, pattern and timetable, which are well established with the committees in the Parliament. However, that is made immeasurably more difficult if there is no UK budget in advance. We would need to reflect very closely if there was no UK budget; as yet, it is not particularly clear from the chancellor or the Chief Secretary to the Treasury whether there will be a UK budget before or after 31 October, or where a potential UK general election might fit within that timescale. I want to give the committee as much notice as possible.

10:15

**Murdo Fraser:** You talked about the UK budget and there has been some suggestion that the chancellor might announce further tax cuts in the UK budget, which would potentially create a larger tax differential between income tax rates in the rest of the UK and rates in Scotland, if you were not to shift your tax policy. Is it your view that Scottish income tax receipts can bear a larger tax differential, or do you think that we might get to the point at which a growing tax differential for income tax becomes self-defeating, and we will actually end up raising less revenue by growing the tax gap?

**Derek Mackay:** Of course, the purpose of having the revenue-raising powers is to raise revenue. I would want policies that achieve the optimal position that is set out in the principles of the use of Scotland's income tax powers in relation to the Scottish budget. The principles are to raise necessary revenue to invest in our public services; to deliver a more progressive system; to protect lower-income earners; and, crucially, to protect the economy. I have said in debates—maybe the point has sometimes been lost in the robust nature of our parliamentary discourse—that there is a point of divergence that runs the risk of not raising the money that we would wish to raise. I have made that point particularly around the top rate of tax. Therefore, I want to understand what the tipping point of divergence is, to achieve the principles of progressivity, raising the necessary revenues to invest in our public services and protecting the economy. The premise of the question is, within those principles, what the acceptable level of any potential divergence is that would also protect lower earners.

Those are the four tests that I would apply and I have said that I would use the Council of Economic Advisers to inform the decision. I am engaging with business directly as well—both business representative organisations and employers—to understand whether the tax regime for income tax, or even business tax, is an issue. I

will take an evidence-based approach to understand what the position is.

Murdo Fraser will understand that I can respond on Scotland's tax proposition only if I know what the UK's tax proposition is, because that drives the figures, the fiscal framework and the relative tax that might be derived from any further policy divergence.

I believe in a more progressive income tax system. I am advised that the commitments that the UK Prime Minister, Boris Johnson, made in his campaign might not necessarily translate into Government policy, but the budget will tell all with regard to that tax proposition and we will respond as a Government accordingly. Parliament can then decide whether it supports that tax proposition.

I draw attention to the fact that, although the budget process goes through negotiations in and is subject to the determination of Parliament, we must pass a rate resolution for the budget to be complete. If no rate resolution is passed, no income tax would be raised in Scotland, which would have a massive effect on financing the public services of Scotland. However, I will take any decision around the tax rates with the four principles in mind.

**John Mason (Glasgow Shettleston) (SNP):** The figure of £1.1 billion has been mentioned. You have said that some figures get thrown around and they are more suggestions than promises. Is the £1.1 billion in consequential absolutely solid—is it set in stone—and would it survive a change to a different Conservative Government, or to a completely different Government?

**Derek Mackay:** The point that I made at the spending review is that the numbers cannot be guaranteed until a UK budget is set, because that will determine the figures. I am going on the spending review figures as announced for one year by the UK Government, but the UK Government will have to get such a budget through the Westminster Parliament in the usual fashion.

Of course, the overall envelope for Scotland is also determined by the fiscal framework—the tax policies, the block grant adjustment and the reconciliation within that. Therefore, the £1.1 billion is not the whole story, and it is still subject to a UK budget, which is why the timing and the determination of the UK budget is significant. The substantial part of those consequential is the resource that is specifically for the national health service, and of course Scottish Government policy is to pass on those resource Barnett consequential to health.

**John Mason:** Sometimes there has been doubt as to whether the money that is being announced is new, or whether some of it has already been

announced and is being restated. Is that a risk in this situation?

**Derek Mackay:** Again, we see the detail of Barnett consequential in terms of how the money is proposed to be allocated to Scotland. That is notwithstanding the financial and fiscal disputes that we have with the UK Government. It is based on Barnettised spending. As I said, all those other factors come into play to tell us how much resource we will have overall in the block grant but, when it comes to what will flow to Scotland, as the basic premise of the question, that will still be subject to a UK budget.

**John Mason:** Is the worst-case scenario that Westminster, as it used to do, might go back to announcing its budget in March? We would be in a difficult position.

**Derek Mackay:** That would be an incredibly difficult position, because the Scottish Parliament will be expected to have concluded its processes by then. When it comes to the budget, local government will want its settlement numbers over January and February. All parts of the public sector will want their figures. That would cause maximum turbulence to the parliamentary timetable, which we have established and would want to honour, and we have not spoken about Brexit yet.

I hope that a responsible UK Government will deliver the UK budget sooner rather than later, in order to give everyone in the UK some certainty. The devolved Administrations have made the point about how critical it is to have awareness of the timing for the UK budget.

**John Mason:** Thank you.

**The Convener:** I know that John Mason wants to ask questions about VAT. I will come back to that. Patrick Harvie has questions on the spending side of the equation.

**Patrick Harvie (Glasgow) (Green):** Good morning. Before I ask about spending, I want to clarify a point on the tax side that you discussed with Murdo Fraser. In answering his questions, you seemed to accept one of the assumptions that was embedded in it, which I do not think is right. If the UK Government chose to cut tax for the highest-income people, who need the least help, it would be choosing to create a bigger tax differential. However, it might choose to reduce income tax for low earners, who, at the moment, pay more tax south of the border than they do here. If the UK Government chose to make that tax cut, it would reduce the tax differential. Is that accurate?

**Derek Mackay:** I understand and support that view, but it is not the proposition from Boris Johnson. In his campaign, he is proposing to cut

personal income tax for the richest in society. The Scottish Government, the Scottish Parliament and the Greens have not mirrored that position. We believe in a more progressive tax system.

I did not accept Murdo Fraser's premise; I simply set out the four principles that I would deploy. We want to set tax rates that achieve all four objectives, one of which is to raise the necessary revenue. There is a point—this is based on evidence—that has the potential of raising less revenue rather than more, because of tax divergence. I understand that point. I am trying to deliver a more progressive system.

**Patrick Harvie:** I was not suggesting that a sensible, progressive tax policy seems likely to come from Boris Johnson's Government. In principle, those decisions are UK Government decisions. If there is a bigger tax differential as a result of UK Government decisions, that is a matter for it. We should compare tax in this country with what we think it should be in a better, fairer Scotland rather than with what it should be down south.

**Derek Mackay:** Absolutely. That is why I set out principles, including a more progressive system, to raise the necessary revenue to invest in our public services. My track record to date has been that I have delivered a more progressive system while being sensitive to the issues that affect Scotland's economy.

I have also said that, having moved to the five-band system, we have a settled structure in relation to income tax in Scotland.

**Patrick Harvie:** I will move on to the spending side. We all understand that you are not in a position to disclose what will be in the published budget and that there is still some degree of uncertainty. However, if the overall effect of the Barnett consequentials offsetting against the reconciliation is a real-terms increase, although that is unlikely to reverse more than 10 years of austerity, there will be a lot of interest in where that money will go.

You should now be in a position to answer questions about the pre-budget process that you are going through in order to arrive at the budget. Last year, you made the commitment that, prior to the budget this year, there would be a process of discussion with local government about the construction of a three-year settlement. Is that process already under way? Is progress being made towards that objective, which is an existing Scottish Government commitment?

**Derek Mackay:** The discussions with local government have begun. Just yesterday, there was an education-themed discussion with the Deputy First Minister, and there will be a health and social care-themed discussion. I will meet

local government regularly, as I normally do in constructing the budget, and I will have on-going dialogue with it.

I intend to give local government illustrative numbers if that is clearly what it desires. I know the position that we took in the negotiation with the Greens on a multiyear settlement with local government, but it is difficult for me to set out clear numbers for a multiyear spending review, as the UK Government has cancelled its multiyear spending review.

We will be able to produce a one-year budget and then engage with local government on future years for illustrative figures, but there cannot be a multiyear settlement because I will not have figures for future years from the UK Government. However, I will continue to regularly meet local government.

**Patrick Harvie:** You did not have future years figures from the UK Government when you made the commitment to a multiyear settlement for local government. Are you saying that that commitment is no longer extant?

**Derek Mackay:** No, I am not saying that. I can give local government future years numbers, but it will understand that I cannot give concrete numbers because the UK Government has cancelled its proposed spending review. I know that I said to the Finance and Constitution Committee when we were trying to undertake a multiyear spending review that that would be incredibly difficult to do if the UK Government did not conduct a spending review as well, because that drives many of our numbers.

**Patrick Harvie:** I appreciate that. However, I make a comparison with the Scottish Government's existing manifesto commitment for multiyear increases in real terms for the NHS—in fact, increases for the full length of the parliamentary session. I am sure that we all support that commitment. That shows that it is possible to make a long-term commitment in the absence of long-term funding from the UK Government.

**Derek Mackay:** That is a fair point. Elements of the budget have been determined on a multiyear basis, but they will include component parts such as investment in early learning and childcare and investment in housing. Those are good examples of areas in which we have made a multiyear commitment. Digital is another example.

I know that this is pre-budget scrutiny and I still wish to give local government multiyear numbers, but I think that it would accept that, as the UK Government has cancelled the spending review that drives the largest share of our total block, it is difficult to set out concrete numbers for future years. That is even before we get into the volatility



of the additional elements of the fiscal framework or what the economy may face as a consequence of Brexit.

I will engage constructively with local government and, of course, I will work to honour the deals that I have made through budget negotiations. I am simply being clear that, if Parliament expects me to set multiyear budgets with that level of unknowns and that volatility, that will be difficult, and I am not sure that the numbers would be credible. However, I will be as constructive as I can be in setting out the multiyear numbers.

**Patrick Harvie:** I understand the point that you are making—

**The Convener:** You should ask one more question.

**Patrick Harvie:** I have one final point. Again, this is simply to clarify whether previously stated Scottish Government positions on its long-term budgeting goals remain the same. When you ended the public sector pay cap, you said that that was the beginning of a “journey of restoration” of the value of public sector pay. Does that remain the position?

It has also been said that the entire capital budget is under review in light of the First Minister’s statements about the climate emergency. In looking at your capital budget, what processes are being undertaken to review existing capital projects in light of those statements?

**Derek Mackay:** The Scottish Government still sees the benefit of multiyear budgeting and those comprehensive spending reviews. It is the UK Government that has, for whatever reason—I will not get into the politics—moved away from a multiyear spending review to a one-year spending review and therefore a one-year budget, which then drives the numbers. As a matter of policy, we still aspire to multiyear spending reviews and we still want to undertake the budget process through the prism of our outcomes focus, which includes the net zero emissions agenda, wellbeing, and tackling child poverty.

10:30

On the capital aspect, I propose to set out a one-year capital budget. However, because we will be advised by the Infrastructure Commission for Scotland, we will review the infrastructure pipeline and, as we have set out, the Scottish national investment bank’s primary mission will involve such interventions on our journey towards net zero emissions, and our budgets—including capital budgets—will have to reflect that. Therefore, there will be a review of capital to ensure that it aligns with that policy priority and the

climate emergency that the First Minister has declared. I will propose a one-year capital budget and we will then make further capital decisions by midsummer. I set out that capital approach in the medium-term financial strategy, but the climate emergency will certainly feature in our capital plans.

**Patrick Harvie:** Thank you.

**Alex Rowley (Mid Scotland and Fife) (Lab):** I have a couple of questions. On page 11 of last year’s budget document, you said that each spending department would be asked to make efficiency savings of 3 per cent and to report back to the Parliament on them. How is that going?

**Derek Mackay:** Efficiency savings are effectively reinvested. The budget was set out and ultimately approved by the Parliament, and portfolios make savings as well as receive allocations.

Our finances will continue to be challenging. To return to John Mason’s earlier point, even the Barnett consequentials will not make up for the 10 years of austerity that we have faced. The position will still be challenging as we move forward, even with the consequentials that have been announced so far. We will expect portfolios in all parts of the public sector to continue to show efficiencies as we deliver our front-line public services.

**Alex Rowley:** There was a specific statement in your budget document that efficiency savings should be made and reported back to the Parliament. I have not seen any of that happening, so I assume that it has not happened.

I cannot find the reference in my papers, but my reason for making that link with efficiency savings is that you seem to have increased the reserves. Is there any relationship between the efficiency savings and the amount by which the reserves have increased?

**Derek Mackay:** No. I have covered reserves in statements to the Parliament. Efficiency savings are reinvested. Reserves can arise from tax receipts, underspends or late Barnett consequentials. I have set out the position on reserves. The figure is far smaller than what is often reported in the public domain. However, I would be happy to check the efficiency reports. If they contain more information that I could share with the committee, I will certainly do that.

**Alex Rowley:** I turn to spending and Barnett consequentials specifically. It was mentioned that there would be an additional £87.8 million in capital. I would like to have that clarified. Let us focus on education spend. Have you shifted the methodology as far as capital spend for education is concerned? I am picking up from local

authorities that there has been such a shift. It seems that you will pay them revenue and they will do the borrowing.

**Derek Mackay:** In the previous budget, local government had a capital uplift. Some of that was for specific purposes. Some £150 million was to pay back to local authorities what had effectively been borrowed from them under an agreement that had been reached with them. There was also £50 million for the town centre fund. As you have mentioned, there was traditional support in the capital departmental expenditure limit capacity for local government. The Deputy First Minister has made a further funding announcement on how we might fund the future learning estate, which would require a contribution from local government. That should hardly be surprising, given that the school estate is a statutory and primary function of local authorities. However, in continuing the Scottish Government's journey of massively improving the quality of our estate to a point at which school buildings are in a satisfactory state, a new funding model is available. That takes into account rules around borrowing and the hub model. There is a new financing tool for funding school improvement, which local government has largely welcomed because it represents extra finance to support the journey of school refurbishment and renewal.

I would be happy to give the committee more information on the specifics of that. That is not to the detriment of local government; it is in addition to the capital that local government might choose to spend on its school estate programme.

**Alex Rowley:** I would welcome additional information on that.

On spend, the accountants say that the Barnett consequential would be £635 million for health and £324 million for education. A lot of people seem to find it difficult to see the spending on health and social care. Money seems to go into local government and NHS boards, but even the people on the joint health and social care boards seem to have difficulty trying to work things out.

Do you accept that there is a perception that there is a transparency issue around funding for health and social care? Are you willing to address that in the budget? Would it not be easier to have a ring-fenced budget so that people could see clearly what is being spent on health and social care, given that it is one of the areas in which demand will grow at an accelerated pace because of Scotland's demographics?

**Derek Mackay:** That is one of the first times that Alex Rowley has argued for a substantially ring-fenced budget. However, I understand the reason for the question.

I would not say that the process lacks transparency, but it is complex because of the nature of health and social care integration. That has been well received, and it is important that the resources are now being targeted to those who are in greatest need. In the past, there has been a debate about and conflict between social care and health. We are trying to bring them together, but it is true to say that that money is sometimes routed through health and sometimes through local government, partly because local government has expressed concern about the pressure on social care budgets and partly because health also has a responsibility there.

The question is whether there is a better way of doing it. I think that there is, but we should discuss that in partnership with local government and health services to align resources and achieve integration in its fullest sense. I am willing to address that, but there is complexity in understanding where the different funds are and bringing things together. That is a reason to continue our integration journey.

The most important thing is that the resources should reach those who are in need and that the system should respond to demand. That is partly why we have been able to allocate resources to health and the health and social care integration agenda. There are inextricable links between those who are in hospital and those who should be in the community, and we have to make the resources available to them through partnership between local government, health and the integration joint boards.

**The Convener:** The issue of reserves was brought up during that exchange. Gordon MacDonald has questions about reserves and forecasting.

**Gordon MacDonald (Edinburgh Pentlands) (SNP):** My questions are about forecast errors. The majority of organisations have to deal with one set of forecasts, but when you set the Scottish budget, you sometimes get different forecasts from the Office for Budget Responsibility and the Scottish Fiscal Commission. What difficulties and uncertainties does that create?

**Derek Mackay:** The difficulties and uncertainties are self-evident in the reconciliation numbers that are emerging and in the new advice that we have received since the fiscal framework was first agreed. Those reconciliation numbers are substantial for 2021-22. The reconciliation numbers for 2020-21 could be dealt with in the reserve drawdown and the borrowing capacity, but that is not the case for 2021-22. That is driven by the SFC and the OBR numbers.

We have rehearsed that issue regularly in the committee, and the committee has taken evidence

on it from the SFC and the OBR and on the application of the reconciliation numbers through Her Majesty's Revenue and Customs. Essentially, there is an immense difficulty in working on two sets of forecasts when the methodology for both is different. They drive the drawdown number that we use to determine the budget, which we then have to reconcile once the numbers are finalised, which the outturn report speaks to. The situation is complex and volatile, and it will be difficult to manage with the range of potential error. It is nothing to do with economic performance; we are discussing forecast error issues based on what the economists find. That level of volatility is a concern—so much so that I have raised it with the Chief Secretary to the Treasury.

In the Economy, Energy and Fair Work Committee meeting yesterday, I was asked about our borrowing capacity, and Jackie Baillie asked about economic volatility and Brexit in particular. With regard to tax reconciliation, the current figures go beyond our drawdown limit and our reserve borrowing capacity. That is a concern to me, as it would be to any finance secretary. I have asked the UK Government to consider the parameters around the fiscal framework and our borrowing limits, so that we have more tools to smooth out and respond to the issue.

For those reasons, the issue is a concern. That is why I have raised it with the Treasury. I am happy to share with the committee the letter that I wrote to the Chief Secretary to the Treasury subsequent to the meeting that I had with him.

**Gordon MacDonald:** You have touched on the £200 million for the 2020-21 budget. It has been suggested that the figure could be as high as £608 million the following year. The committee heard from the Scottish Fiscal Commission that the OBR's track record on forecasting had an average absolute error rate of 3.3 per cent, which equates to roughly £500 million per annum. Therefore, you could be facing large adjustments year on year for the next few years. Do you believe that the fiscal framework is fit for purpose?

**Derek Mackay:** That was the point that I was trying to express. The framework as a set of principles was fine but, with the rolling out of that volatility, a forecast error of more than £600 million, which we are now being advised might be a regular occurrence, is a concern. If we take the reserve borrowing limit, even if we had reserves stored away, the maximum that we could draw down could not accommodate such an error every year. One year is difficult. Even though the SFC has said that a row of negative reconciliations might be followed by a row of positive reconciliations, that is not much comfort when we are facing the negative reconciliations. The reserve borrowing capacity should be reviewed as

a matter of urgency because of that new evidence and the new reality. That forecast error is a concern. That is why I have raised the issue and why I believe that the position needs to be reviewed.

**Gordon MacDonald:** Thank you.

**Alexander Burnett (Aberdeenshire West) (Con):** I want to ask about landfill tax. I am sure that the cabinet secretary takes no joy from the rather unique situation of failures elsewhere in Government having produced additional revenue for his budget. Is there a case for spending that windfall directly on addressing the problem of landfill? Given that the Cabinet Secretary for Environment, Climate Change and Land Reform has talked about missing the landfill ban target, what confidence does the cabinet secretary have in the rest of the forecast figures going forward?

**Derek Mackay:** I know that Alexander Burnett has chosen to use some slightly pejorative language by blaming the Scottish Government, when actually most waste collection policy is decided by local government landfill operators and waste companies. Let us all take responsibility for the fact that we should be working together to deal with waste and have as little going to landfill as possible. The environment secretary can speak to the decision around the relaxation on the issue, but we are very focused on trying to reduce the amount of waste that goes to landfill.

10:45

Of course, if more waste goes to landfill, there is a fiscal benefit, because more landfill tax is raised. We wanted less landfill tax to be raised, because raising more landfill tax represents more waste going to landfill. However, when some local authorities and operators expressed the concern that there was a risk that we could create waste tourism, in that the waste would be sent south of the border, we had to respond in a pragmatic fashion. I am not allocating blame but, for that reason, there is the potential of increased tax. It is another relative tax. Let us see what happens with the block grant adjustment, and in England, when it comes to that waste issue.

I am loth to hypothecate funds for taxation in the same way that I am loth just to photocopy a chancellor's budget, when we have different principles and a different approach. We will allocate resources according to our environmental agenda and towards the climate challenge but I am loth to hypothecate particular funds into the future. The fiscal framework is complex enough without adding another layer of complexity.

Will we have that focus on investment to achieve future targets around waste? Yes, we will.

**Alexander Burnett:** We all agree that addressing landfill is an issue that we should all be working on, at whatever level.

I do not think that you answered the second part of the question. Given what the Cabinet Secretary for Environment, Climate Change and Land Reform said, how accurate are the revenue figures for landfill tax?

**Derek Mackay:** Economists have given a view on how accurate the figures are. If memory serves me correctly, the forecast was made before the change in policy from the environment secretary, so I expect the figures to be reviewed in the light of that.

**Alexander Burnett:** Thank you.

**The Convener:** Derek Mackay raised the issue of Brexit a couple of times. Tom Arthur has questions on that area.

**Tom Arthur (Renfrewshire South) (SNP):** Four weeks tomorrow, the UK is scheduled to leave the European Union. The latest dispatches to emerge overnight suggest that the prospects of a deal being reached by that point are remote. Although the Benn act is in place, we cannot rule out that procedural jiggery-pokery will render it null and void. There is a real prospect of a no-deal Brexit on Halloween. Cabinet secretary, what would be the impact of a no-deal Brexit on your assumptions and budget planning?

**Derek Mackay:** As I expressed earlier, right now, I do not know when the UK budget will be. I do not know whether the UK Government knows when the UK budget will be. I do not think that it fully knows its content.

I have seen rhetoric in the public realm—the chancellor has talked about having an “economic response”. By that, I envisage that he means that he understands the economic consensus that if there is a no-deal Brexit, we will be entering a recession. There will be business failure and soaring unemployment, communities and their most disadvantaged people will be affected, there will be impacts on transport and on supply and demand, the contraction in the economy will be severe, and exports will be affected. All that is a negative economic consequence and would feed into the fiscal decisions that the UK and Scottish Governments would have to make.

We have allocated and committed the Brexit consequential that we have received. I have covered the cost to the economy but the information that I have today is that the cost to the Scottish Government and our agencies to execute our no-deal Brexit plan will not be covered by the UK Government. It will mean choices within Government as to how far we can go with our contingency plans, or what else needs to be

reprioritised or cut, in order to mitigate the impact of that no-deal Brexit. I agree that, as a consequence of the Prime Minister's and the UK Government's handling of the situation, that feels more likely than ever. It will have a catastrophic effect on our economy and a negative impact on the fiscal position of Scotland.

**Tom Arthur:** Has the UK Government given you any indication of what its fiscal response would be to a no-deal Brexit?

**Derek Mackay:** Over the most recent period, the engagement from the UK Government has been poor. Its papers have leaked—yellowhammer and kingfisher. We have had some engagement, but it has not been satisfactory and has given no clear indication of forward-looking fiscal policy that would assist us to make decisions on how to respond. We cannot possibly mitigate the full impact of Brexit. I am clear about that, and the UK Government should be more transparent about its plans.

**Tom Arthur:** Notwithstanding the possibility of a no deal, the fiscal framework is a product of the pre-Brexit world. What are the implications for the fiscal framework review of the post-Brexit world that we might be entering?

**Derek Mackay:** I have tried to cover what we already knew about the fiscal framework. Information and evidence is unfolding on the levels of volatility, especially in income tax reconciliations, and social security pressures will come into play in Scotland's budget. Added to that is the volatility of Brexit. Our borrowing powers will be rendered totally inadequate in the face of the economic catastrophe that will come as a consequence of a no-deal Brexit.

**The Convener:** Angela, is your question on the same area?

**Angela Constance (Almond Valley) (SNP):** No.

**The Convener:** I will take you next anyway.

**Angela Constance:** Good morning, cabinet secretary. I want to explore income tax receipts in the context of wage growth.

Both the outturn report and the Fiscal Commission forecast point to income tax receipts increasing every year. We know that income tax reconciliations have been due to faster wage growth in the rest of the UK, particularly among higher earners. The committee has heard evidence that achieving higher income tax revenues requires pay growth across the income distribution, and that pay growth at the top end should not be at the expense of its growth across the piece.

As well as being alive to the issues of inequality within Scotland, does the cabinet secretary feel that Scotland has an additional risk of losing out as a result of increasing inequality elsewhere in the UK? What, if anything, can we do to mitigate that?

**Derek Mackay:** I genuinely think that there is a real risk, which perhaps was unforeseen. It can only be fully understood as we get more data about the tax that is actually collected in Scotland. The SFC has said that it will need further years of data to understand whether there is a structural or a cyclical issue. However, it is true to say that inequality in the rest of the UK is deepening as the top earners are earning more proportionately and as a quantum. That is not so much a feature in Scotland, because we have fewer top-rate taxpayers and because the income distribution in Scotland is different.

There is a distribution issue and an unforeseen structural issue. As the evidence unfolds, there is a case for the UK Government to reflect and acknowledge that the issue is not about economic performance, but about increasing inequality in the UK.

In Scotland, we have to look at income distribution. Of course, we want greater equality in income, redistribution and employment, and to bring more people up through the living wage and all those other mechanisms. However, your analysis is correct: an issue is emerging.

I have raised with the UK Government specific issues about the bottom end of income distribution. The spillover issue arose when the UK Government raised the personal allowance, which is for those who are paid the least. Understanding that distribution issue, we felt there was a case for the UK Government to consider that spillover effect on those at the bottom of income distribution, and understand that in raising the personal allowance, Scotland loses out under the fiscal framework.

There is a range of policies to support wage growth in Scotland. However, there is a specific issue in the UK about those at the top being paid relatively more, which is a reflection of deepening inequality across the whole of the UK. We can do what we can in Scotland, but we cannot stem that, and it then has a material impact on our numbers.

**The Convener:** John Mason has questions on VAT.

**John Mason:** I realise that I was not on the committee when it discussed with the cabinet secretary VAT and the challenges around that previously. Will the cabinet secretary give us an update on where we are at the moment?

**Derek Mackay:** I have raised the issue of VAT, my concerns around the methodology, and—more important—my concerns around volatility, particularly in the potential Brexit scenario.

If a no-deal Brexit comes to pass—and it feels more likely that it will—we will be using a baseline during that period of transition at potentially the most volatile point, and we will be dealing with the consumer confidence issue and the potential impacts of a recession. At that point of maximum volatility, we could be taking on VAT assignment, which would add to the overall volatility of the Scottish budget.

I have expressed my concern to the Treasury and to the new Chief Secretary to the Treasury, who was hearing it for the first time from me directly, and I think that he is reflecting on it. I am advised that a letter might be coming from the Treasury fairly imminently. Once I receive an update from the Treasury, I can return to the committee. However, my position on wishing assignment to be deferred for those reasons has not changed.

**John Mason:** As I understand it, with all the other taxes—such as landfill, land and buildings transaction tax and income tax—at some point, we are dealing with the actual numbers that Scottish people pay. Is part of the problem with VAT the fact that we are never dealing with the real numbers, because they are not recorded anywhere, and that we are always going to be working on estimates?

**Derek Mackay:** That is correct, and it is part of the problem. However, I am also trying to be pragmatic and realistic by saying that we could have further negotiation on VAT if the UK Government gives us the tools to help smooth the volatility. If we get a realistic proposition from the Treasury, the Scottish Government will compromise. However, we cannot just take on VAT at the point of maximum volatility, in addition to the other pressures that we are facing, and with a lack of tools to address that volatility. Of course, it is not a power; it is only an assignment that is based on estimates, with no reconciliation and no final outturn figures.

We have worked really hard on the methodology, and I do not know how much further we can go on estimates. However, there would never be complete and finalised numbers with which we could say, “Yes, that is categorically what was raised in Scotland.” I would try to compromise with the Treasury if there was a further compromise around the levers to address that volatility, especially in the context of what I described earlier, and if there was an understanding about the volatility that we are facing right now. I do not know whether that is of assistance.

**John Mason:** That is helpful. You are saying that there are extra problems because of Brexit and volatility, but that there is also a long-term problem as to how we actually do this. If we built a new factory here, which would add value, I would have thought that we would tax the added value of what the factory produced. However, as I understand it, that is not even on the table.

**Derek Mackay:** Yes. The committee has also discussed that and shared some of those concerns, and it is not alone. The Fraser of Allander institute said:

“A key aim of the Smith Commission was to improve accountability and make Scotland’s politicians responsible for the money that they spent. Unfortunately rather than helping to deliver this aim, the current proposals for VAT assignment risk undermining that principle.”

The concerns around it are, therefore, widely shared. However, if the UK Government can provide further solutions and remedies to those challenges, we can engage further. I am advised that a response to my request is imminent, which I will share with the committee as quickly as I can.

**Murdo Fraser:** I will follow up on John Mason’s questions, because the cabinet secretary said something interesting about seeking additional levers to address volatility around VAT assignment. By additional levers, are you talking about increased borrowing powers or something else?

**Derek Mackay:** I am talking about increased resource borrowing powers. That is a very helpful set of parameters. If we consider the income tax reconciliation that I discussed and the parameters that were agreed at the time, we now know that negative income tax reconciliation could be as much as £600 million a year for a few years. If we also take into account social security volatility and VAT volatility, the current limits are rendered inadequate.

I will always ask the UK Government to give us a fairer settlement and our fair share of consequential, but here I am asking it to give us more tools to do our job and to meet our responsibilities responsibly. Increased borrowing capacity would be one good way in which to do that. However, we have to have confidence in the methodology around VAT and be assured that it is as close to what is actually raised in Scotland—relative to the rest of the UK—as possible.

**Murdo Fraser:** Thank you—that is very helpful. Are you able to put a figure on the level of additional flexibility that you are looking for?

11:00

**Derek Mackay:** So far, I have raised the issue of income tax reconciliation, the letter about which I will share with the committee, as I have said. I

have not set a figure on VAT because I genuinely want to discuss with the Treasury what a compromise would look like. It wants us to take on assignation, not a power. I would quite like to have the power to set VAT, because it would be a more helpful economic lever to pull in response to Scotland’s specific economic challenges or to policies that we might wish to make. It is only assignation, but I have not got into figures on VAT.

The discussions that I have had so far have been primarily about income tax volatility and permissions relating to the Scottish national investment bank. However, the committee will understand that the current constraints on the drawdown limit and the borrowing limits will inadvertently affect the bank too, which is why I have tried to engage with the Treasury on that matter. I do not think that the answer is no, so I am continuing to engage with it as constructively as I can.

**The Convener:** In a letter to the committee of 30 May, about personal allowance policy spillovers, the UK Treasury accepted that

“the above-inflation increase to the personal allowance”

had

“constituted a change to the policy”

and that it was

“considering the Scottish Government’s analysis of this issue.”

It went on to say:

“If the Scottish Government and HM Treasury agree on the methodological approach, we will consider if any transfer of funding ... is due for these years.”

Where has that got to?

**Derek Mackay:** That Chief Secretary to the Treasury has been moved on and I now have a new one to deal with, who is considering the information that the Scottish Government has presented. I do not yet have any conclusion from the Treasury, because it is still considering the matter.

**The Convener:** That has been going on for some time now, though.

**Derek Mackay:** Indeed it has. We have been pursuing the Treasury in that time. I have to say that at my first face-to-face meeting with the new Chief Secretary to the Treasury, I was quite frustrated. In fairness, he was catching up with his brief, as only three weeks had passed since his appointment. I did make efforts to engage with him early on, but it is clear that we need progress on all those matters. I accept that the UK Government is incredibly busy right now—as we all are—but we need a satisfactory conclusion to give us certainty as we move forward.

**The Convener:** I thank the cabinet secretary and his officials for giving evidence.

11:02

*Meeting continued in private until 11:28.*

At the start of the meeting, we agreed to take the next agenda item in private, which we will now do.





This is the final edition of the *Official Report* of this meeting. It is part of the Scottish Parliament *Official Report* archive and has been sent for legal deposit.

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