OFFICIAL REPORT
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Finance and Constitution Committee

Wednesday 29 January 2020

Session 5

The Scottish Parliament
Pàrlamaid na h-Alba

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FINANCE AND CONSTITUTION COMMITTEE

2nd Meeting 2020, 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:

Mairi Spowage (Fraser of Allander Institute)

CLERK TO THE COMMITTEE

James Johnston

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Finance and Constitution Committee

Wednesday 29 January 2020

[The Deputy Convener opened the meeting at 10:00]

Budget Scrutiny 2020-21

The Deputy Convener (Adam Tomkins): Good morning everyone, and welcome to the second meeting of the Finance and Constitution Committee in 2020. We have received apologies from our convener, Bruce Crawford. We wish him well—he will be back with us soon.

The first item on our agenda is to take evidence on the strategic context of the Scottish Government's budget for 2020-21 from the Fraser of Allander institute, which published its annual report in November 2019. We have with us Mairi Spowage, deputy director of the Fraser of Allander institute. Welcome to the meeting, Mairi. I understand that you wish to make a few opening remarks to set the conversation in context.

Mairi Spowage (Fraser of Allander Institute): Thank you very much for inviting me to speak today about the context of next week's budget. Our November report was our fourth annual budget report. Obviously, it was prepared before the election took place. However, given the outcome of the election, pretty much all the analysis in it remains valid in setting the overall context for the Scottish budget.

We looked back in the report on the budgets over the course of this session, and it is fair to say that the fiscal context, as with many other things, has changed fairly dramatically since 2016. Back then, our outlook was for a significant period of belt tightening as the United Kingdom Government sought to bring down its deficit and its stock of debt. It now appears that we are in a period of increasing spending, particularly following the announcements in the spending round in September.

What else has happened since then? Significant new powers have been devolved to the Scottish Parliament over the intervening period, and they have been used fairly extensively to change taxation in Scotland. The practical implications of the agreed fiscal framework are beginning to be realised, with real budgetary implications for the Scottish budget. During that period, there has been significant political and economic uncertainty, dominated by the debate over the UK's departure from the European Union.

What does that mean for the year to come? In line with the announcements that were made in September, our outlook is that the resource block grant will grow by around 2.1 per cent in 2020-21. Given what we know now, it will probably grow by a similar amount in the year after. That is fairly healthy in the context of recent years, certainly compared with the outlook that we had back at the beginning of the session. Of course, that view comes before the UK budget in March and is based on the September announcements, so there is of course some uncertainty to the figures.

Some of the positivity in the outlook for the resource block grant could be, and probably will be, offset by negative income tax reconciliations, with about £200 million confirmed in the budget next week and a potentially much larger reconciliation coming down the road for the 2021-22 budget. That may mean that the resource block grant will grow by less than 1 per cent overall in real terms over those years, but it all depends on the numbers that come over the next few weeks.

There are some signs that wage growth in Scotland has improved compared with the previous outlook, so it may be that the reconciliation for 2021-22 is not as large as is currently estimated but, as you know, there are many moving parts that make that uncertain. We will know more next week, when the forecasts are updated by the Scottish Fiscal Commission, and we will have the final answer on the reconciliation when the outturn data are published in the summer.

We are reaching an important landmark for the devolution of the Scotland Act 2016 powers in April 2020, when financial responsibility for the majority of social security powers is transferred to the Scottish Parliament. That means that the budget for 2020-21 and beyond will be exposed to new risks, as well as bringing new opportunities for the powers. That is a mirror image to the risks around tax. There is a risk that spending on benefits per head will grow more quickly in Scotland than in England and Wales. Additionally, there is the risk of forecast error, which could happen on both sides of the equation, by the Office for Budget Responsibility and the Fiscal Commission.

This year, we have the complexity of the Scottish budget taking place before the UK budget, in the wake of a year of various types of uncertainty. That is clearly a suboptimal situation for the Scottish Government and for the Parliament, given the constrained time for scrutiny and the uncertainty over the budget situation. We have done quite a lot of thinking about the risks of that sequencing of the budgets, so I am happy to say more on that issue if the committee is keen to talk about it.

I am happy to answer questions from members.

The Deputy Convener: That is helpful—thank you. You have raised a number of issues that members want to explore with you in greater depth.

I will start with the issue of sequencing, which you finished on. On page 35 of your report, you state that there is “unprecedented ... uncertainty” around a number of elements that inform the Scottish budget and that, in “normal times”, the UK budget would precede the Scottish budget. However, is it not the case that, when the fiscal framework was agreed between the UK and Scottish Governments back in February 2016, the UK budget was published annually in March? The fiscal framework was drafted on the basis that the Scottish budget would normally be passed before the UK budget. If that understanding is correct, is it not the case that the fiscal framework was designed precisely to deal with the UK budget being published after and not before the Scottish budget, or have I misunderstood that?

Mairi Spowage: You are correct that, when the fiscal framework was agreed, that was the case. At that time, there was the autumn statement and the March budget. There are a number of moving parts in relation to the risks of the UK budget coming after the Scottish budget. Some are a function of what has happened over the past year and some are a result of the UK budget coming after the Scottish budget—those are separate things. When the fiscal framework was set, it was envisaged that the block grant adjustments would be set at the time of the autumn statement, even if the budget was not produced until March. Therefore, there are different sorts of risks for the Scottish budget in the current situation.

When the framework was set, the BGAs were to be set at the autumn statement, so the Scottish Government would have known what those were going to be and the impact on the budgetary year. Obviously, there might be reconciliations down the road, but the impact in that year would have been certain. However, there would be uncertainty around the potential for UK policy announcements at the March budget and other announcements that could change the block grant. Those risks were present at the time of the agreement of the fiscal framework, so you are correct about that.

The Deputy Convener: Obviously, the process this year is different from the one that we went through in the past two or three years, but we need to be careful not to exaggerate the nature of the process that we are in now and say that it is completely unprecedented.

Mairi Spowage: Yes. We are in an unusual situation, based on our experience of the past few years when the tax powers have been in place and have been used. Do you mind if I go through the different sources of uncertainty that the situation brings us?

The Deputy Convener: That would be helpful.

Mairi Spowage: As we all know, there are a number of moving parts that make up the Scottish budget. The first area of uncertainty is the block grant. Given the return of the Conservative Government and Sajid Javid as Chancellor of the Exchequer, following the spending announcements that he made in September, it seems likely that the broad envelope of the Scottish block grant is known with a fair degree of certainty. Of course, there might be further spending announcements and tweaks to departmental spending, but it seems unlikely to us that the announcements at the budget will lead to a smaller increase in the block grant than was announced in September. Therefore, on the block grant, there seems to be a limited downside risk for the Scottish budget.

Obviously, provisional block grant adjustments have been provided to be used for the Scottish budget, and those were updated by the OBR prior to Christmas to reflect outturn data but, importantly, they were not updated to reflect new economic forecasts, because the OBR has not produced any since March last year. What are the risks of using those provisional figures? Leaving aside any UK Government policy changes—I will need to come back to those—I think that there is a risk that the OBR could change its view on wage growth in the rest of the UK. Given the narrative that it has had, I think that the risk of significant change is not very high, but small changes in those assumptions can lead to large changes in cash terms to the forecast of the block grant adjustments.

In addition, the OBR could have a view that is different from the one that it had last March on the outlook for social security benefits and new additions to the case load. Benefits such as the personal independence payment are still quite new and entries to the case load can be fairly volatile. One can say that, if those are locked in and used to fix the budget, there is a chance of larger reconciliations down the road than would otherwise have been the case, but the reconciliations could be in either direction.

Derek Mackay has asked for the flexibility to use the updated versions of the block grant adjustments in the event that they are beneficial to the Scottish budget envelope, but I understand that he is still awaiting a reply from the Chief Secretary to the Treasury.

The final risk is UK policy change, which is potentially a more significant issue for the Scottish budget and the Scottish Government, although perhaps more for policy and political reasons than because of any immediate fiscal consequences. If there is a change to UK policy on income tax or stamp duty, for example, the use of the locked-in BGAs would not affect the budget that we are about to set, but it would increase the risk that the provisional BGAs are a poor estimate of the ultimate BGAs that are used in any reconciliation. Essentially, the can would be kicked down the road, although it would give the Government time to plan how to deal with the matter.

There is a political or policy risk that UK policy announcements make the Scottish Government's policies look in some way unsustainable or unviable by comparison.

Overall, given the fiscal rules that have been announced so far, based on the details that we have, it is quite difficult to see how large tax cuts, for example, are actually going to be offered. We will not know until the UK budget is unveiled.

The Deputy Convener: If the biggest risk is attendant on UK budget changes, the key point is that those changes would always have been announced at the budget which, when the fiscal framework was drafted, was in March, after the Scottish budget. Therefore, that risk is factored into the way in which the fiscal framework was designed to operate. Whether it is operating as designed is a different question, but it is factored into the way in which the fiscal framework was designed to operate.

Mairi Spowage: Yes, at the time of the agreement of the fiscal framework, although it was generally welcomed when the budget was moved to the autumn in order for there to be more certainty and more time. Whether or not the motivation for that was to allow the Scottish Parliament's budget process to happen in an orderly fashion, to go back to the March arrangement would be a step backwards. I do not think that anyone would argue with that. In a way, it could cause tension between the two Governments with regard to respect for the budget process.

The Deputy Convener: That is a very helpful introduction. Thank you.

Angela Constance (Almond Valley) (SNP): I think that we all appreciate that there are always risks as well as opportunities, but will you make a more evaluative statement about the cumulative risks of the Scottish budget taking place before the UK budget? In particular, what is the cumulative impact, given the use of block grant adjustments, which, as you said, are normally set in autumn? Layered on top of that is the risk around BGAs being calculated without updated economic forecasts—you touched on the impact of the lack of knowledge about UK Government tax policy and said that small changes can lead to large cash changes.

10:15

Mairi Spowage: It is difficult to do an overall assessment of the risk. The risk seems low to moderate for each different element, but if lots of different things were to come to pass, that could look quite different from what we expect.

Our view is that the chance of downward change to the block grant is fairly low and that the risk of UK Government policy announcements in devolved tax areas in the budget in March is fairly low. If the provisional BGAs are locked in, even if they are significantly different from the BGAs after 11 March or, when we are talking about income tax, in a year or two's time, there is time to deal with and manage that risk. As we wrote in a blog that detailed our thoughts on the issue, it creates additional uncertainty.

There are two elements that make the situation this year more uncertain than the situation when the fiscal framework was agreed. It is unprecedented that we have not had a forecast from the OBR in a year, during which time its thoughts will have evolved, which makes it uncertain where it is going to land on things such as social security payments.

Overall, we do not think that the risks are as great as some make out, but it is certainly a suboptimal situation to be in, particularly given the constrained period for scrutiny that the Parliament now has.

Angela Constance: Given that there is a well-known potential volatility in the Scottish budget—other colleagues will talk about social security—do you think that, on balance, that volatility is exacerbated by the late UK budget? Do you think that the reserve and borrowing limits under the fiscal framework are adequate for a budget of this size?

Mairi Spowage: In relation to the budget that is about to be set next week, if the BGAs are locked in and the block grant is as we expect, it will be possible to plan based on the announcements in September fairly well for the next couple of years. I am not sure that the late UK budget is necessarily causing volatility in the Scottish budget envelope, but if there were unexpected spending announcements in March, there would be an argument for that, given that it could affect the BGAs significantly, which would lead to reconciliations that are larger than would have been the case if they had been set in the autumn.

Your other question was about the borrowing limits that were set out in the fiscal framework. Given the perfectly reasonable unexpected errors that may occur in forecasts of a tax as big as income tax, the errors of 2 to 3 per cent that we have seen in the OBR's forecasts are generally accepted as representing a good performance. If we take that error rate for an £11 billion tax and accept that that could happen in the Scottish forecast and in the BGA forecast, potentially in different directions, the provisions in the fiscal framework look small given the risks being managed in Scotland.

Add to that the fact that those powers will have to be used to manage the risks around social security payments, which can be more tricky to forecast than tax take particularly if they are devolved, the policy changes or the method of assessment changes. Assessing what each of those changes would mean for take-up and therefore expenditure is a challenge, because there is limited evidence on which to base assumptions about how they might influence case load and expenditure in the future.

Angela Constance: The fiscal framework is due to be renegotiated in 2022. Do you have any views on what the outcome of that renegotiation should be?

Mairi Spowage: That is obviously for the two Governments to decide. What has become clear in the practical workings of the fiscal framework is that it is very complex. I have done enough talks on block grant adjustments to know that it is pretty difficult for people to wrap their head around it. Once we start adding in social security in earnest, along with the different sorts of reconciliations that will happen on the social security side as opposed to the tax side, it is understandable that a lot of people in Parliament and among the wider public might find it difficult to engage with how the budget in Scotland is determined.

That said, all the decisions about exactly how such things are worked out were made for good reasons, and it can be difficult to see what an alternative would be. Nevertheless, there is definitely an issue around complexity and the wider understanding of the fiscal framework. In my view, any expectation that forecasting errors will be smaller in the future than they have previously been is not reasonable. Such errors are perfectly in the range of what should be expected, and the Parliament should have some sort of mechanism to deal with them if we are going to continue into the future with the current systems.

Gordon MacDonald (Edinburgh Pentlands) (SNP): What is the outlook for Scotland's economy, and the fiscal outlook? Brexit is just around the corner—31 January is at the end of this week, although the transition period does not end until 31 December—and we do not yet have a trade agreement in place, nor do we know how long such an agreement will take to negotiate. Given the implications for freedom of movement, access for European Union workers and tourism, what impact could Brexit have on the Scottish budget?

Mairi Spowage: There are a number of uncertainties around the outlook. We have seen a definite uptick in confidence since there has been some short-term certainty around the fact that we will leave the EU at the end of this week. However, businesses are now worried about what comes next: what happens at the end of the year and what will that mean for their trading position?

There are a number of areas of uncertainty for the Scottish budget. We have a real challenge in Scotland given our demographic outlook, for example. The outlook for Scotland in terms of our ageing population is very different from the outlook for England, and we therefore have different needs when it comes to the number of people coming into Scotland. The migration flows to Scotland have never been as high as the flows to England, as is shown in the outlook for the Scottish population, and the forecast that our working-age population will start falling has serious implications for our tax take. If more of our population is no longer of working age and is not paying income tax, our tax base will get smaller, which has implications for the Scottish budget. Those are all risks and uncertainties for the future.

Gordon MacDonald: Would the fiscal framework provide any kind of support or safety net if that situation came to pass?

Mairi Spowage: The fiscal framework protects against overall population risk on both the social security side and the tax side. The important question is whether tax receipts per capita grow at the same rate as the equivalent taxes in the rest of the UK—or, depending on the type of tax or social security payment, in England and Wales or in England and Northern Ireland.

Per head, if our population grows more quickly than the population across the rest of the UK, the budget will be better off, and the opposite is also true. However, per taxpayer, if less of our population is paying tax and more of our population is not paying tax, the framework offers no protection from that risk.

It is a similar case for social security payments. If more of our population is older, and some of the benefits that are being devolved are linked to disability, which can increase with age, it could be that the per capita benefit payments are higher than those in England and Wales. We are not protected from that risk, which is one of the consequences of the devolution of benefits.

Gordon MacDonald: On page 2 of your 2019 budget report you asked:

"Will ... the potential for radical 'Brexit' tax proposals cast a shadow over the forthcoming Scottish budget?"

What did you mean by that?

Mairi Spowage: That chapter was written by our colleagues in the Institute of Chartered Accountants of Scotland. Charlotte Barbour was referring to the potential for significant changes to income tax and to the greater divergence that that would create between UK and Scottish tax policy. It would further exacerbate the additional issue of the national insurance threshold rising with the higher rate threshold at the rest of the UK rate. It would mean that a larger portion of the Scottish taxpayer population was paying income tax at a marginal rate of 53 per cent.

Gordon MacDonald: We have touched on social security already, but I will move on to another point. The BGA forecasts have not been published. In your report you said of the newly transferred social security benefits that

"not knowing how much its grant will increase to fund this expenditure is a real problem for the Scottish Government."

Could you expand on that?

Mairi Spowage: At the time, we did not have the figures, but we do now have provisional figures for the block grant adjustments for social security.

Based on the forecasts that the Scottish Fiscal Commission most recently provided, it looks as if the block grant adjustment—the addition to the budget—will be more or less the same as the forecast for those expenditures in 2020-21. Those are based on provisional figures. If those figures are used and are locked in, we have some certainty about 2020-21 and about the fact that the block grant adjustment will cover the forecasted expenditure—but it is only forecasted expenditure. We do not know what the expenditure will actually be.

Gordon MacDonald: Given the difficulties that we had with forecasting income tax prior to the devolution of those powers, are you sure that the forecasting for social security expenditure is accurate?

Mairi Spowage: Until the figures were published in the summer of 2018, we did not have figures for how much income tax was raised on an administrative basis in Scotland. We used the survey of personal incomes and we discovered subsequently that that method had overestimated the tax base in Scotland, particularly at the higher end. We are not in that situation with social security. We know how many people receive those payments in Scotland. It is administrative data and we know, with certainty, what the base is.

The greater uncertainty for social security lies in forecasting. It is about policy changes. If you change your approach, perhaps by encouraging take-up, or if an assessment process is less stringent or rigorous, or if you have a lot of campaigns, those things are intangible in terms of quantifying the impact that they may have on take-up. However, if they do increase the take-up of benefits that people are eligible for, or if eligibility is changed or made more generous, that will have an impact on spending on social security payments. Forecasting is more difficult for social security than it is for tax, as there is a greater evidence base for how tax policy changes may lead to changes in the tax paid.

The Deputy Convener: What has always slightly puzzled me is not the comparison of social security to tax but the comparison of social security to other demand-led public services. The health service is demand led, but we do not seem to have the same anxieties—perhaps we should—about forecasting health spending as we currently seem to have about forecasting social security spending. What is different about social security spending that makes it more risky for the Scottish Government than the health budget?

10:30

Mairi Spowage: I suppose that it is because social security is purely demand led and we will spend what we spend on it, so there will not be a budget set that we will then work to. The eligibility criteria will be in place and people who apply and are successful will be paid that money. Forecasts of demand-led expenditure are more risky because we could spend a lot more than forecast in any one year.

The Deputy Convener: How is social security different from the health service?

Mairi Spowage: A budget is set for the health service.

The Deputy Convener: Okay. Murdo Fraser has questions about something else.

Murdo Fraser (Mid Scotland and Fife) (Con): I have lots of questions about the block grant adjustment, but before I come to that, I will follow up Gordon MacDonald's earlier questions on the economy and its impact on tax receipts. Last week, the employment and unemployment figures came out. They showed that Scottish unemployment and UK unemployment are now at the same rate, but that the Scottish employment rate is 2 per cent below the UK average. A comment from the Fraser of Allander institute that went along with that suggested that it was the highest gap in two decades.

I am interested in the impact that that has on tax revenues. I presume that if the Scottish employment rate rose to at least the UK average, that would have a very beneficial impact on overall tax revenues and therefore on the Scottish budget.

Mairi Spowage: Potentially, yes. In making judgments about the forecast of total tax take, obviously the Scottish Fiscal Commission will look at trends in employment and unemployment and in earnings. Crucially, though, it is about how that employment translates into tax take and a large proportion of people in Scotland are lifted out of income tax altogether. It depends on what those jobs are, and a forecast will be based on patterns that we have from historical data on wage distribution in Scotland and how employment translates into tax take. Yes, in principle, higher employment would lead to higher tax take, but it depends on the wage distribution of the employees.

Murdo Fraser: Thank you. I have two questions on the block grant adjustment. You said in your opening remarks that you expected the block grant from the UK Government to grow by 2.1 per cent in real terms from this year to next, but you went on to say that, because of the block grant adjustment for the forecasts for tax revenues, the growth would be down to 1 per cent. Are you in effect saying that more than half of the benefit of the block grant increase will be lost because of slower growth in devolved tax revenues? If that is the case, how does that translate in cash terms?

Mairi Spowage: It is about the combined effect of two things: the difference between the block grant and the net position after we take account of the taxes. We have to take account of the fact that income tax will not contribute as much to growth in the overall Scottish budget envelope as it has in previous years, because of the weaker outlook for wage growth in the Scottish Fiscal Commission’s most recent set of forecasts. We also have to take account of the reconciliation that will come as part of the 2020-21 budget.

Overall, combining those factors takes the block grant growth down to 1 per cent, but there are significant uncertainties. Obviously, the reconciliation is about £200 million and there are other uncertainties that can feed into the overall size of the Scottish budget. For example, there might be further spending announcements, underspends or the use of the reserve. There are other things that could mean that the overall size of the Scottish budget grows by somewhere between that 1 and 2 per cent level.

Murdo Fraser: Thank you.

In your report, you comment on the additional income tax that the Scottish Government has raised by changing the thresholds and bands, but you also go on to say that there has been a relative decline in income tax receipts compared with the rest of the UK, because income tax growth in Scotland has not been as high. Had income tax growth in Scotland matched the UK average, would it have been necessary to make those changes to thresholds and bands to raise the extra money?

Mairi Spowage: At the time that the policy changes were made, they were forecast to raise additional money, despite any differences between tax growth in the rest of the UK and in Scotland. When those policies were set, it was broadly assumed—for example in the 2017-18 budget—that wage growth in Scotland would be the same as in the rest of the UK. That has not come to pass, so reconciliations are coming. Looking ahead, the effect of the higher tax rates in Scotland is broadly cancelled out by the fact that the outlook for wage growth in Scotland is slower than in the rest of the UK.

I am not quite answering your question; it has come the other way around.

Murdo Fraser: We have come to the same point, so that is very helpful. Thank you.

Patrick Harvie (Glasgow) (Green): I want to follow up that last point. Assuming that the economic conditions were unchanged, in other words that the difference in wage growth that had not been expected was still happening, is it fair to say that if the changes to income tax policy had not been made, then we would still be in a worse fiscal position—that the revenues would be significantly lower than under the previous tax regime?

Mairi Spowage: Yes, absolutely.

Patrick Harvie: Is there any strong evidence to suggest that the changes in tax policy have caused the difference in wage growth?

Mairi Spowage: I would not like to say that there was any evidence one way or the other. In terms of a tax change, it is very early days for evaluating any impact on behaviours or overall wages.

Patrick Harvie: I want to move on.

Most of the conversation so far has been about the context: the conditions that the Scottish Government is facing. What might it be trying to achieve with the budget that it is due to publish next week? The report that you published in November talks a little about the Scottish Government’s interest in a wellbeing economy and in what that might mean. The report makes a comparison with the dashboard of indicators in the national performance framework that was published some years back, and refers to the slightly ambiguous definition—some would say the complete lack of definition—of sustainable economic growth, how that can be broken down, and what it means in practice. You raised the possibility that wellbeing might suffer from the same problem of a lack of definition, or of a lack of clarity about what it means in practice. Can you unpack that a little? Do you regard a wellbeing economy approach as holding any positive opportunities, or is it a distraction?

Mairi Spowage: It is true that Governments should be about improving the wellbeing of society. I do not believe that Governments pursue economic growth for its own sake; I believe that they pursue it because they see it as a way to increase the prosperity of their country and the living standards of their people.

It is true that it is hard to pin down the words that we use when we talk about "the purpose of sustainable economic growth" or "focusing on inclusive growth in our wellbeing economy", for example, in terms of what they mean for policy making and budgetary decisions. More specific outcomes need to be set out with regard to what those concepts actually mean for society and which interventions the Government can prioritise in order to achieve them. In our report, we say that such language can simply look like window dressing or moving the deck chairs around in order to present budgets in different ways without any meaningful change to how decisions are made.

There is an interesting debate around how Governments can make decisions in a way that promotes aims such as reducing inequality rather than increasing growth. A lot of that is about how individual policies are evaluated and what is taken into account. That is happening with the green book evaluations, for example, and with how infrastructure projects are prioritised and where they are undertaken. Are such projects carried out where they have the greatest economic multiplier or where they could have the biggest impact on inequality? Those are decisions that a Government can make—if it wishes—to address such problems.

I agree that, unless there is more definition of what is meant by terms such as "prioritising wellbeing" or "a wellbeing economy" that are linked to specific actions and to budgets that are to be spent on achieving those aims, it is difficult to see such language as anything other than a bit of a public relations exercise. We understand that there are plans for a wellbeing budget, or some sort of framing of the budget in that sense, so it will be interesting to see what that is like. The document that New Zealand produced through a similar process is very interesting. It says, "These are the specific things that we want to deal with in order to improve the nation's wellbeing, this is the money that we are going to spend on them and these are the outcomes that we want to achieve in these particular areas." It has prioritised particular things in order to achieve that.

Patrick Harvie: In a way, it is a very old problem. Things that are easy to measure, such as gross domestic product, sometimes tell us less. There are things that are good for GDP that make poverty, inequality and health impacts worse, and there are things that are bad for GDP that improve society in some ways. The opposite is also true; there is not a simple connection.

Do you feel that the approach that New Zealand is taking is worth exploring? Does it require a level of tangible, measurable specificity, or is it possible for the concept of a wellbeing economy to achieve its objectives by focusing on things that are perhaps less easily measurable than GDP?

Mairi Spowage: The evidence from various incarnations of the idea over a number of years has shown that, if there are no specifics, it is too difficult to both capture progress and hold people to account. We need specifics with regard to what the concept means and the decisions that need to be made. Let us face it—decisions will have to be made in order to prioritise things such as preventative spend or a focus on poverty. We would need to specifically state that, in using terms such as "inclusive growth" and "a wellbeing budget", we mean that we are going to focus on reducing poverty.

We have to remember that New Zealand set its wellbeing budget in the context of a budget surplus, so it had money to spend. It focused on new spending rather than on a huge rearrangement of its existing budget. There would be potential challenges for Scotland in looking at the budget in that way, and we would need specific information about that approach in order to make it meaningful for people.

Patrick Harvie: I know that other members want to talk about local government in its own right, but I want first to make the connection between the idea of a wellbeing economy and local government.

Is there a danger that, in taking a wellbeing approach, the Scottish Government would focus only on its own fiscal actions—that is, on what is spent by that tier of government? If cuts are pushed down the chain, with local government expected to decide whether to protect education and cut other spending more deeply, the decisions that harm wellbeing would not be made by the Scottish Government, and it would then be able to say that the things that it was doing protect wellbeing.

10:45

Is there a danger of a disconnect between that sense of an objective—what we are trying to achieve—and the level at which decisions are taken if those more dangerous or damaging decisions on cuts are pushed down the chain and if the real-term cuts to local government carry on?

Mairi Spowage: As we say in our report, local government has borne the brunt of cuts in recent years. The report shows that local government protected certain areas, as you have said, and therefore basically every other area of local government spending has been squeezed hugely, including spending on roads and other civic amenities.

In any dashboard of wellbeing, societal wellbeing or overall good growth that I have seen, such things as local community and civic engagement are extremely important. Feeling like they live in a good community and participating in local democracy are really important for people's wellbeing.

I suppose that my answer to your question is yes, potentially—if there is not a partnership to reach the same goals between different layers of government and the new, or newish, initiatives such as city deals and city regional partnerships, which are spending a lot of money in different areas of the country.

Patrick Harvie: Some of the city deal spending has been criticised for not aligning with long-term strategic priorities.

The Deputy Convener: Neil Bibby wanted to go into that space. Would you like to pick up that point?

Neil Bibby (West Scotland) (Lab): Just before I do, I was interested in Mairi Spowage's comment about the wellbeing approach being a public relations exercise and window dressing.

Mairi Spowage: I said that it could be seen as that.

Neil Bibby: Why do you think that? Do you think that it is an attempt to deflect attention from weaker economic growth and weaker tax revenues?

Mairi Spowage: Not necessarily. It is really difficult to rethink a whole budget and how different budget lines could contribute to things that are intrinsically harder to measure than how many pounds they add to gross value added. This is difficult stuff; it is not always easy to draw the line between particular policies and how they impact all the time on societal wellbeing.

I suppose that you could make the argument that it is an attempt to deflect, but that is not what I meant. I meant that rethinking the budget in that way is not easy. In order to reshape the budget to focus on things that may be more long term or more preventative, you may have to make difficult decisions, which is not easy to do.

Neil Bibby: Have you been able to measure the impact that the city deals are having on local economies and the Scottish economy?

Mairi Spowage: We have not done that. We are working with people who are involved in city deals, but we have not done any work to evaluate the impact. There is a question about some of the assumptions in different city deals about the benefits to the economy that they will all bring to all parts of Scotland. How much of that will happen or how much might be displacement from other parts of Scotland is an interesting question.

Neil Bibby: We have already touched on the issue that, to grow the economy and grow tax revenues, we need to be careful about our capital investment and ensuring that we get the biggest possible impact for the economy from that investment.

More widely, looking at the Scottish Government's resources on a Scotland-wide level, do you think that there is any evidence so far that the significant investment that has been made in capital is having the desired impact in relation to growing the Scottish economy and revenues?

Mairi Spowage: Over the past couple of years, there has been pretty poor data on business investment in general. Although public investment is obviously very important, business investment has been very subdued over the past couple of years, which will undoubtedly be having an impact on the economy. I have not seen much evidence about the impact of investment on economic growth so far, but a lot of the impact will be seen in future years. These projects have a long lead-in time, so it may take a while for their impact to come through in the figures.

Neil Bibby: Is there any analysis of how the Scottish Government's capital investment could be spent more effectively? We have spent billions of pounds on capital infrastructure projects in different areas. Has any analysis been done of whether spending that money on different projects, in different ways and in different sectors would result in a more positive impact on the economy?

Mairi Spowage: I will make a couple points. It depends what you are trying to achieve. If you have wider goals, rather than simply GVA—

Neil Bibby: Let us say that the goal is growing tax revenues and the economy.

Mairi Spowage: From a pure economic modelling perspective, the more local the supply chain, the bigger the impact on the Scottish economy. Obviously, when you consider things such as construction projects, there is a certain level of import propensity in relation to importing from both the rest of the UK and the rest of the world. If you import things from outside Scotland, you will not get supply chain impacts. That is one of the biggest issues in relation to the actual impact on the Scottish economy, if you are looking purely at the GVA or employment impacts of a particular project,

The Deputy Convener: We are moving slightly away from the focus on the budget. Alexander Burnett will ask some questions about local government budgets.

Alexander Burnett (Aberdeenshire West) (Con): Local government has seen a reduction in funding of nearly 8 per cent since 2013. You have correctly identified that some areas, such as maintenance, have been hit harder than others. That point is particularly pertinent when it comes to Aberdeenshire, where bridges are being closed. On page 70 of your report, you discuss the analysis of the effects of the situation. Do you do any economic analysis of either the short-term economic effect or the long-term costs that are building up?

Mairi Spowage: We have not done any economic analysis of the long-term economic effects of the cut in local government funding.

Alexander Burnett: The failure to maintain assets will lead to greater costs in the future. How are we accounting for that? If we are not recording or dealing with that depreciation accurately, how accurate are the forecasts on which we base our budgets?

Mairi Spowage: In terms of economic growth in Scotland, or—

Alexander Burnett: We can all see things happening, whether it is pot holes or bridges closing. However, when something goes wrong, there is an additional cost, or loss of tax revenue and all the rest of it. It is like a cliff edge. When a bridge closes, it is suddenly a massive thing. People do not seem to understand that if something is not being maintained annually and then goes wrong, the cost of dealing with that is bigger. Where are we providing for that, and, if we are not providing for it, should we? If it is not being provided for, how accurate are the forecasts?

Mairi Spowage: That sort of modelling is difficult to do, and it is not our area of expertise. A lot of that is to do with transport links and losses in productivity, for example, as a result of disruption caused by bridge or road closures if significant maintenance work is required. We have not done any work on that, but I agree that it would be an interesting area to look into.

John Mason (Glasgow Shettleston) (SNP): A few points in your report have not yet been touched on. On pages 28 and 29, on income tax, you address the concept of behavioural change. People sometimes think that behavioural change simply means moving around the place, but it also covers incorporation. A self-employed person has the option to operate either as a sole trader or partnership or as a limited company; there is movement in both directions. You suggest in the report that it might be preferable for them to operate as a limited company, particularly if the corporation tax rate falls. However, you also note that Her Majesty's Revenue and Customs has been doing some work to try to ensure that people are not operating as a company when they should in fact be employees. Can you expand on that? Is there an overall trend there?

Mairi Spowage: As I understand it, the overall trend is that tax-motivated incorporation—that is the catchy term—has been increasing. That is one of the reasons why HMRC brought in the IR35 regulations to try to prevent disguised employment. Those regulations may or may not reverse the trend of tax-motivated incorporation somewhat—that is yet to be seen.

The important consideration for Scotland, with regard to its tax base and the implications for its budget, is not just whether that trend is happening, but whether it is happening at a different rate in Scotland in comparison with the rest of the UK. If it reduces the Scottish tax base by a certain percentage and it is happening at the same rate in the rest of the UK, there will be no overall net impact. Similarly, if the IR35 regulations mean that the trend starts to reverse and more people move into the employed population, there will be no net overall impact as long as that happens at the same rate as in the rest of the UK.

The question is whether the different tax regime in Scotland has a differential impact in terms of the incentive to incorporate, and whether that impact will be wiped out by the IR35 regulations. That is yet to be seen. HMRC is taking the lead on analysis in that regard, but I understand that it is working closely with the Scottish Fiscal Commission and building in its assumptions about tax-motivated incorporation in Scotland.

John Mason: My gut feeling has always been that a 2 per cent difference in tax rates would not have much of an impact, but there might be an impact if the gap was bigger. When do you think that we will have some idea about the impact? Will we have to wait five years to analyse all the data?

Mairi Spowage: We will need the survey of personal incomes data from 2018-19, and the data for a couple of years after that. We can then use that detailed microdata to analyse the changes in the distribution of taxpayers and that sort of thing.

We will also need the data that HMRC has been collecting on tax-motivated incorporation over that period.

To manage expectations, I would highlight that, even at that point, it will be difficult to know exactly how people have responded, because we do not know the counterfactual: that is, what their behaviour would have been had there not been two different tax regimes in place.

Research can be done a few years after the tax changes to hypothesise and seek evidence from the literature to see what the effects have been. However, that is not easy—it does not involve simply doing a calculation and getting an answer, because there is no alternative reality in which the tax changes have not happened.

John Mason: That was helpful. My second question relates to page 32, which I understand touches on practical problems with VAT assignment. Is that a fair assessment?

Mairi Spowage: Yes.

John Mason: Could Brexit have an impact on that? I think that it was the EU that insisted on the same VAT rates being applied throughout the UK. If that is the case, would the fact that we will no longer be in the EU allow us to change VAT in Scotland? That might be an unfair question. Is there any prospect of putting in place a system that would allow VAT to be broken down according to where it comes from?

11:00

Mairi Spowage: That would be really difficult. Early in the process, the two Governments agreed that there would be a modelled approach to estimating VAT, based on consumption in different parts of the UK. That made sense, given that it is a tax on consumption. However, it appears that the data that is being relied on is not of good enough quality to provide assurance around fluctuations in the budget, which are not only to do with statistical variability.

On the question about having a different system, any system that required businesses to break up their VAT returns between different parts of the UK would obviously have significant implications for them. The question would be whether it was worth increasing the burden on business in order to get information about VAT receipts that are raised in Scotland.

John Mason: That is true. If we attracted a factory to Scotland, it would—I hope—add value, and there would therefore be a VAT implication. However, if we were to look only at where the consumer spend took place, in a sense it would not matter where the factory was, and so there would be no advantage for Scotland in winning that factory.

Mairi Spowage: Yes, I can see your point. VAT liability ultimately rests with the consumer, given that they pay it in the end. However, VAT is a complex tax, and the VAT receipts would not necessarily reflect the factory's location in a particular part of the country.

John Mason: That is fine—I will leave it there.

My next question is about real-time information from HMRC, which you touch on in pages 52 and 53 of your report. Although the report says—if I understand it correctly—that some of the forecasts for Scottish revenues show a decline, it also states that the

> "RTI ... suggests, on the contrary, that this may be a somewhat pessimistic outlook",

which seems to present a more positive angle. On the other hand, however, the report says:

> "There are some important caveats. The SFC is cautious about reading too much into the RTI data".

Who do we trust on that?

Mairi Spowage: To be honest, the SFC has a point. The "Statement of Data Needs" that it published in September 2019 shows that there are quite different messages in the actual outturn data for 2017-18 and 2016-17 and what the RTI seems to imply. They both show growth, as we would expect, but the growth rates are quite different.

The SFC has called on HMRC to help it understand the differences between those sets of statistics. HMRC says quite clearly in its "Scottish Income Tax: Experimental Statistics" publication that RTI is not the same as outturn data. Many factors, such as the higher income child benefit charge, tax code changes and so on, mean that RTI will not necessarily correlate well with outturn data.

John Mason: Does the RTI show the cash-flow situation: the actual cash that is coming in?

Mairi Spowage: Yes, it shows the pay-as-you-earn revenues as they come in. To be honest, I am not an expert on the details of exactly how the estimates for Scotland are produced. In its "Scottish Income Tax" publication, HMRC says that we cannot assume that RTI is the same as outturn data, and it highlights the various differences. However, at the same time, RTI is the most timely source of information on which forecasters can base their judgements.

It is not good enough for HMRC to put the RTI figures out there and then say, "Ah, but you can't assume that they are the same as outturn data." I would agree with the SFC that it is up to HMRC, given that it has all the data, to explain what one can and cannot draw from the RTI data, and why.

The onus should be on HMRC to explain that more thoroughly.

John Mason: On page 72 of your report, you talk about the future review of the fiscal framework, which I think is due in 2022 or thereabouts. You say that it

"should ideally take place much more transparently than was the case for the negotiation of the 2016 framework."

Is that possible? To some extent, the two Governments fudged the agreement in 2016. The two Parliaments—Westminster and the Scottish Parliament—want to scrutinise these matters and how they are done. However, as you said, we have ended up with an incredibly complex situation; the Organisation for Economic Co-operation and Development has said that it is one of the most complex in the world. How could it be made better?

Mairi Spowage: We now have the benefit of knowing what the practicalities of operating the fiscal framework are. Part of the review process is—or should be—about taking views openly from the various organisations that have been involved in the framework. Talking to the forecasting organisations, Governments and commentators who have had to explain the complexities of the fiscal framework—and, to be frank, some of the unintended consequences that have resulted from it—is a helpful part of the process.

We understand that there will, in the end, be political negotiation to come up with a new solution. Nonetheless, it is important—as John Mason said—that the two Parliaments are involved in the process and feel confident that the ultimate decision is evidence based and represents a fair settlement.

John Mason: What has come through in a lot of what you have said is that the framework is based on a comparison between how well the Scottish economy does and how Scottish taxpayers pay tax, and how the rest of the UK does. We might do well or badly, but the key thing is how we compare. When we compare our performance with that of the UK, we end up comparing ourselves with London. However, London is often out of line with the rest of England. Are we always at a disadvantage because we are trying to compete with London?

Mairi Spowage: It is true that, if we compare historical growth rates over 50 years, Scotland has generally lagged slightly behind the UK growth rate, and you are right that a lot of that will be driven by London. However, some of it is about population and that risk is, to a certain extent, dealt with in the current mechanism for the block grant adjustments. The different parts of the UK certainly grow at different rates.

John Mason: Thank you.

Alex Rowley (Mid Scotland and Fife) (Lab): Would it be fair to say, with the benefit of hindsight, that the fiscal framework that was agreed through the Smith commission is a pretty bad deal for Scotland?

Mairi Spowage: No, I certainly would not want to say that. There have been unforeseen consequences. Some expectations—for example, that the forecast errors on the block grant adjustments and the tax receipts would go in the same direction—were reasonable at the time but have now been shown not to be so. We hope that, with the benefit of hindsight, those considerations can be built into any future fiscal framework.

I do not think that it is fair to say that it is a bad deal. One of the consequences of fiscal devolution is that we take on more risk. The question is whether that risk is acceptable and whether we have the levers to manage it successfully.

Alex Rowley: I am always interested in joined-up government, or the lack of it, at every level. As your report states,

"Local government's funding has been disproportionately cut since 2010."

As a result of those cuts, tens of thousands of jobs in local government have disappeared. Is it the case that, as a result of budget decisions, there are fewer people in the economy paying tax?

I am interested in how such decisions have a knock-on effect. Is the Government looking at the impact of decisions in some parts of its budget on other parts?

Mairi Spowage: That is a great question. I do not have the figures for local government employment in front of me, but overall resource spending has increased by more than £1 billion in real terms between 2016-17 and 2019-20. The majority of that has gone to the health budget, and another big chunk is for social security and employability responsibilities.

Therefore, spending on other areas has fallen over that period—local government has taken the biggest hit, and other areas such as higher education and universities have also taken a hit. We have seen a real change in the spending profile; I suppose that it is for the committees and Parliament to say whether that reprofiling of the budget is sensible.

Alex Rowley: As the Scottish Parliament gains more and greater powers, is there a judgment to be made around how the budget is used to drive and stimulate the economy? Could the criticism be made that taking tens of thousands of jobs out of local government was not in the best interests of the wider economy or of local economies?

Let us take, for example, the skills shortages that seem to exist in most key sectors of the Scottish economy. Neil Bibby talked about capital investment earlier. Although there are major capital programmes, we find that we do not have the skills in this country and we have to import them, which affects the level of spend and the benefit from those programmes. Thinking about how the budget is joined up, I wonder whether or not there is a real focus on trying to stimulate and grow the economy in order to make the budget healthier in future years.

Mairi Spowage: That is a great question. It builds on what Patrick Harvie said about what we are trying to achieve through the budget, what the priorities are and whether the money that is spent is having an effect on those priorities. I am not sure that I am answering your question.

Alex Rowley: I move to my final question. On the radio this morning, I heard an interview with the deputy leader of Inverclyde Council. Although Ferguslie Park has come up a bit, for which I am thankful, Greenock's town centre is now the poorest area in the country. The deputy leader was talking about the council's plans for £3 million of investment in the town centre. However, when the interviewer asked him to name the main thing that could help, he said that it would be an end to austerity. That was quite stark.

Where are we at with austerity and its impact? Looking at the wider economy, austerity has arguably failed, given that the economy has not grown and we are now in greater debt than we were before the policy was introduced.

Mairi Spowage: The definition of austerity is obviously debatable. With regard to the overall position of the budget and the block grant, there would certainly seem to be a step change in what is likely to come in the budget that is about to be set. However, it is obviously for the Scottish Government and Parliament to decide where to spend that money and what the priorities are.

The Deputy Convener: I thank Mairi Spowage for her contributions this morning. She has given the committee a lot to think about, for which we are grateful.

I close the public part of the meeting.

11:13

Meeting continued in private until 11:15.

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