



**OFFICIAL REPORT**  
AITHISG OIFIGEIL

# Finance and Constitution Committee

**Friday 5 June 2020**

**Session 5**



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Pàrlamaid na h-Alba

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**FINANCE AND CONSTITUTION COMMITTEE**

**11<sup>th</sup> Meeting 2020, Session 5**

**CONVENER**

\*Bruce Crawford (Stirling) (SNP)

**DEPUTY CONVENER**

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

**COMMITTEE MEMBERS**

\*George Adam (Paisley) (SNP)

\*Tom Arthur (Renfrewshire South) (SNP)

\*Jackie Baillie (Dumbarton) (Lab)

\*Alexander Burnett (Aberdeenshire West) (Con)

\*Donald Cameron (Highlands and Islands) (Con)

\*Angela Constance (Almond Valley) (SNP)

\*Patrick Harvie (Glasgow) (Green)

\*John Mason (Glasgow Shettleston) (SNP)

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

\*attended

**THE FOLLOWING ALSO PARTICIPATED:**

John Cullinane (Chartered Institute of Taxation)

Professor Jim Gallagher

David Phillips (Institute for Fiscal Studies)

Mark Taylor (Audit Scotland)

**CLERK TO THE COMMITTEE**

James Johnston

**LOCATION**

Virtual Meeting



# Scottish Parliament

## Finance and Constitution Committee

Friday 5 June 2020

*[The Convener opened the meeting at 11:00]*

### Public Finances and Fiscal Framework (Impact of Covid-19)

**The Convener (Bruce Crawford):** Good morning and welcome to the 11th meeting in 2020 of the Finance and Constitution Committee.

Agenda item 1 is evidence on the impact of Covid-19 on the public finances and the fiscal framework, in advance of our consideration of the summer budget revision next week. On our first panel are John Cullinane, who is a tax policy director at the Chartered Institute of Taxation; and Professor Jim Gallagher. I warmly welcome you to the meeting. Thank you very much for your written submissions.

I will start with some very general questions. What are the main risks for the Scottish budget that arise from the impact of Covid-19, including on the operation of the fiscal framework? Given the extent of those risks, is there a need to make temporary adjustments to the framework? If so, what should the priorities be?

**John Cullinane (Chartered Institute of Taxation):** Those are very broad questions. We base our comments very much on the practical expertise of our members in operating the tax system, so I am not sure how well placed we are to give a good, honest overview.

It is evident to our members that there will be an effect on the income tax base, and there is a clear risk that that could be disproportionate to the effect on the United Kingdom as a whole. That would reflect the nature of the fiscal framework, so we are clearly getting into very political territory, but that point stands out.

These are not immediate priorities, but I will mention improvements that we could make to the fiscal framework within the current broad political settlement. The crisis has shown that sometimes there is a need for quick responses. It is a relatively modest point in the scale of things, but one example relates to the additional dwelling supplement for land and buildings transaction tax. If people buy their new house before they sell their old one, they are given a period by which to sell their old house, and then they can claim back the additional dwelling supplement. Obviously, the

housing market pretty well seized up during the lockdown. People need more time, and an adjustment was made for that.

That example highlights that tax changes sometimes need to be made quickly. Sometimes, that can be done by secondary legislation, but an annual finance bill or a regular opportunity for primary legislation might be helpful in order to deal with such changes in a way that allows full democratic scrutiny.

**Professor Jim Gallagher:** I will start by distinguishing between the medium term and the short term. In the medium term, the effects of Covid on the public finances will be very substantial. As I said in my written submission, in the medium term, we are looking at an economy that will be smaller overall and in which the public sector will play a larger part, for a variety of reasons. That will be the context in which Holyrood finds itself making tax and spending choices over the next few years.

In the shorter term, referring particularly to the fiscal framework, it seems to me that, to a first approximation, the fiscal framework is doing what it says on the tin and is behaving more or less as it ought to. In particular, in the current year, it has substantially insulated the Scottish budget from the immediate fiscal effects of Covid. For example, it was designed to produce spending certainty and—again, to a first approximation—that is what it has done, because any immediate drops in tax and revenue, or income tax and revenue, are not reflected in a way that impacts on this year's budget.

However, there are longer-term questions about the extent to which, as John Cullinane says, the Scottish economy might be affected differently, and those considerations might invoke the provisions in the fiscal framework. However, I rather doubt whether that will happen.

In the very short term—in the current year—it is appropriate to focus on land and buildings transaction tax, because that is a tax that, under the fiscal framework, the Scottish Government bears the absolute risk of, and it has fallen off a cliff. We do not know exactly by how much it has fallen off that cliff, but transactions have stopped, and it is possible that house prices will have gone down. That is a hit to the Scottish budget that possibly amounts to a couple of hundred million pounds. I wonder whether it might be appropriate for the Scottish Government and the Treasury to agree an adjustment to the framework in order to allow additional borrowing in the current year, so that unplanned reductions in expenditure are not made.

**The Convener:** That is a helpful signal about what one of the committee's priorities should be. I am grateful for that.

My next question is for John Cullinane. I note from your paper that the situation that has been created by Covid-19 highlights the importance of being able to make necessary tax changes quickly without sacrificing scrutiny—you made some comment about that in your first answer. That is a pretty difficult circle to square. I do not want to pre-empt the important work that the devolved taxes working group is undertaking, but perhaps you could give us the CIT's view on how best to solve that particular puzzle about making tax changes quickly without sacrificing scrutiny.

**John Cullinane:** A range of devices could be considered. In Westminster, where there is a tradition that has been brought about by hundreds of years of history, there are budget resolutions that can be used to bring into effect budget proposals immediately. However, such resolutions have a limited time span and must be endorsed by a full primary legislative change later in the year. There are various other options that could be considered.

Nothing can disguise the fact that we are talking about a difficult problem and that time is always short for primary legislation. However, surveys of public views and opinions suggest that people in Scotland—and throughout the United Kingdom, I have to say—have a low awareness of the specifics of the devolution arrangements. If one of the benefits of devolved power is the creation of more relevance and of greater accountability to the people on whose behalf that power is exercised, that is threatened if people simply do not understand the issues underneath all the complexity around the framework and what is decided in Westminster versus what is decided in Scotland. We think that it would be desirable to find some way of bringing the maintenance of the tax system into the ambit of regular review by the primary legislators.

**The Convener:** Finally, I have a question for Jim Gallagher before I go to Jackie Baillie. In your paper, you state:

"Persistent overestimation of income tax revenues, wholly unrelated to Covid, has left a large gap in the budget."

Can you clarify what you mean by that? Is that referring to the Scottish Fiscal Commission's forecasts for Scottish income tax?

**Professor Gallagher:** Yes, primarily it refers to the Scottish Fiscal Commission's forecasts, which have proved to be overoptimistic. As you will remember, the background is that we had to start somewhere when we made an assumption about income tax revenue, so we started with the

"Government Expenditure and Revenue Scotland" numbers, which turned out to be too high. That was maybe not surprising, because they were based on survey data rather than actuals.

We have had to make a transition to actual Scottish income tax revenue. The Scottish Fiscal Commission's job has been to forecast what the actuals will be. I am not necessarily saying this in a critical sense, but the commission's estimates have always proved to be too high.

The first presenting issue is that the forecast number of people who pay higher rates of tax has not been as high as the commission predicted. My view is that that reflects the structure and relative performance of the Scottish economy over the period.

The idea is that we reconcile to actuals over a period of three years as the income tax revenue trickles in. The aim of that is to give the Scottish Government and the Scottish Parliament spending certainty in each year, but the result is that the adjustments are carried forward to future years. It turns out that, in recent years, all the adjustments have been negative and all of them have been pushed forward. The Scottish Government has not taken the opportunity—if you want to call it an opportunity—to adjust spending downwards because it is short of revenue, and it has postponed all those adjustments until after 2021, which might be a magic date for political reasons, of course. The result is a big gap in the Scottish Government's budget at that point, and that is not a great time to have a gap.

**Jackie Baillie (Dumbarton) (Lab):** I want to pursue a bit further the question of the risk of differential impacts on the economy and some of the consequences that that will have in terms of the fiscal framework. It is difficult to judge—we do not know any of this with any degree of certainty—but commentators have suggested that we might face a greater risk, because we have been in lockdown longer, because more businesses have closed north of the border than south, and because of our reliance on the oil and gas industry and the tourism and hospitality sectors. I will start with Jim Gallagher. Do you believe that we will suffer a reduction in the budget as a consequence of that greater risk?

**Professor Gallagher:** You are asking me to forecast the future, which is the one thing I do not know very much about. There is certainly a risk that what you suggest could happen, and that the risk could come from the causes that you suggest, but it could also reflect the different structure of the Scottish economy in comparison with that of the UK economy as a whole.

Two things might be relevant. One is a greater dependence on sectors that are badly affected.

You have mentioned oil and gas, which is not so badly affected by Covid, although it is having its own issues at the moment. Then there are the leisure and tourism sectors, and we do not know what the relative effect will be in those sectors. Obviously, leisure will be hit across the whole country, but it is possible that, in the medium term, Scottish tourism might actually do rather better if people holiday in the UK rather than abroad.

The countervailing factor is that we have a larger public sector in our economy, which will not be affected. It is about what the balance of all these things will be. We should remember all the time that we are talking about relative decline. We are not going to be on the up; the question is how far down we go.

11:15

**Jackie Baillie:** In your submission, you talked about co-operation and collaboration between the Scottish and UK Governments. We have witnessed that during their response to the Covid-19 crisis. How important will that be going forward, and should we trust in those relationships occurring informally or do we need a formal mechanism to make sure that that collaboration happens effectively?

**Professor Gallagher:** I think that co-operation will be even more important in the reconstruction phase than it has been in the immediate phase of dealing with the epidemic. Governments have tried pretty hard to work together during the initial phase of the epidemic. To a degree, they have laid aside their pre-existing differences and mistrusts. That has begun to unravel a little—it is not appropriate to go into that here—but both levels of Government will have to co-ordinate with each other in finding the right way to reconstruct the economy after this event.

One striking thing about the 1999 devolution settlement is the extent to which the functions of the different levels of Government were well separated. There was not a lot of overlap, but the one explicit bit of overlap in the settlement relates to economic development, which is a function of both levels of Government.

In the circumstances that we are about to enter, the tools that each level of Government has to influence the economy need to be co-ordinated. Examples are the UK Government's furlough scheme and how it is phased out, and the UK Government's business loans and how they are phased out, guaranteed or repaid. Further examples are the corporate taxation system—for example, do we allow provisions in corporation tax against investment in the way that we once did?—and the Scottish Government's microeconomic interventions through grants to businesses and its

approach to infrastructure, education and retraining, for which there will be substantial demand. Those things need to be co-ordinated. Our Governments are going to find that very challenging, and we need to hold their feet to the fire.

**Jackie Baillie:** Is a formal mechanism needed? Does one exist to enable such collaboration between Governments?

**Professor Gallagher:** As you will remember, the existing mechanism is the joint ministerial committees, which have had a chequered history over the past decade or so—indeed, for longer than that. We have collectively failed to find really good mechanisms through which the Governments can work together.

At a constitutional level, I have come round to the view that, in general and irrespective of the present crisis, they should have statutory underpinning. Maybe that would help. However, in the end, there is no substitute for our political leaders, who may have their big differences, nevertheless getting together, co-operating as best they can and resisting the temptation to fall back on the tropes of normal politics, which they are good at and know how to do. We are asking them now to manage a crisis and a huge programme of economic restructuring. It is a very big ask, but people have the right to ask it.

**The Convener:** We now go to Angela Constance, but I am not sure whether she has a camera, so it may be sound only.

**Angela Constance (Almond Valley) (SNP):** Good morning. It is indeed sound only—I am not sure what happened, after our preparations earlier.

Following on from Jackie Baillie's questions, I would like to ask Professor Gallagher about what he describes as the immediate challenge of engaging constructively with UK ministers as they form policy. It takes two to tango, and there needs to be a willingness and an openness to early engagement. Can Professor Gallagher say a bit more about some of the other challenges, over and above the mechanisms that the committee has debated a lot? We heard from David Heald that the UK is one of the most fiscally centralised countries. The UK Government has borrowing powers that the Scottish Government does not have and, without being partisan, I think that it is accurate to say that there is a power imbalance. There are also some long-standing cultural differences rooted in organisations and institutions. How can we take things forward?

**Professor Gallagher:** Those are big questions. In answer to the first question, on the level of centralisation and decentralisation, the UK as a whole has traditionally been a fiscally centralised

country. England is still very fiscally centralised, and something needs to be done about that, but that is a different issue from the one that you want me to address.

In terms of fiscal devolution in Scotland, Wales and Northern Ireland, the UK is, by international standards, very decentralised. The proportion of expenditure and taxation that is decentralised in the UK is broadly comparable to that in Canada and Switzerland, which are two of the most fiscally decentralised systems in the world. Therefore, the degree of fiscal centralisation may be a bit of a red herring in the present circumstances.

There is a power imbalance between Governments, and central Governments—federal Governments in federal systems and the UK Government in the UK system—all tend to hold more of the cards. That is why there is often a default to saying that the central Government must do more in a crisis. However, central Governments need to work with devolved Governments for the reasons that I gave in my answer to Jackie Baillie.

You are absolutely right to say that it takes two to tango. I cannot dance for the life of me, but I know that in dancing it is sometimes necessary for one partner to take a steering role and one to understeer a bit. The relationship between the Governments might be a very difficult one because of the politics, but—I am sorry, because I am going to repeat what I said to Jackie Baillie—the expectation that we have to have of Government ministers on both sides is that they will lay aside their preconceptions and capacity to default to normal politics. Among ministers at Westminster, there is often an assumption that they are the central Government and can behave in a certain way because of that, and ministers in Holyrood might default to saying, “We should have more power.” We need to put both those things aside now and find constructive ways to rebuild the economy after this crisis.

**John Cullinane:** I totally agree with what Professor Gallagher said about the need for co-operation. It is almost impossible to imagine a system that was so technically perfect that you could dispense with the desirability of co-operation and there would not be big costs if that co-operation was not forthcoming.

I suggest that it is worth focusing not only on the absolute level of devolved power but on the coherence of the borderlines, because the more they are frayed and do not make a lot of sense, the more stress is placed on the need for co-operation.

I will give an example. The income tax level of a businessperson with an unincorporated business will be fixed at Holyrood, whereas if their business was incorporated, their corporation tax and the tax

on the dividends—their personal income, which they take out of the company—would be fixed at Westminster. There is already an imbalance in the tax levels at Westminster for the equivalents of those people in England, and the more rates diverge in Scotland, the more stress is placed on that. That is quite independent of the stresses and strains that would always come about when a country or jurisdiction varied income tax rates. It just reflects oddities in the settlement.

You could look at the borderline for such features. That would have to be done by agreement with Westminster, and it would probably require Westminster legislation. There are measures that could be taken around the borders of the system that, without changing the world in terms of levels of devolved power, might make more sense and might leave the need for co-operation to focus on the really important things.

**Angela Constance:** I want to pick up on a point about borrowing powers and economic development. As Professor Gallagher said, economic development is a shared competence. He mentioned that the impact of the Covid crisis has been different across the four nations, which reflects the fact that our economies are different.

An issue that has been raised with the committee in other evidence is the fact that the Scottish Government cannot borrow to fund additional Covid-19-related spend. The borrowing limits that exist are not designed to enable us to deal with a crisis or to be fleet of foot. Does the lack of borrowing powers limit the Scottish Government’s ability to respond effectively to a crisis such as the one that we are going through? Would more borrowing powers allow a greater response to support economic recovery?

**Professor Gallagher:** I think that that is a wee bit of a red herring. The extraordinary response to the crisis at a UK level has involved a colossal additional amount of borrowing by the UK Government. Of course, it could always have been more, but it is pretty substantial. That has fed into the Scottish economy directly, mostly through the furlough scheme, which has maintained aggregate demand in the economy in a way that we have never seen before, and secondarily—but very substantially—through the Barnett formula. The committee is probably more up to date than I am on the flow of Barnett consequentials but, as I recollect, it lies somewhere between £3 billion and £4 billion at the moment.

Therefore, I think that leaping to the idea of additional borrowing powers as the answer is premature. As I said in my written evidence, the most important thing to do is to find an integrated approach with the UK Government so that devolved and reserved powers work together on

this. I have heard it suggested that the immediate response should be for the Scottish Government to borrow not from the Treasury but on its own account, by issuing bonds. I think that that would be a very silly thing to do at this time, not least because, astonishingly during this crisis, for the first time ever, the UK Treasury has been able to borrow at negative interest rates. The capacity to borrow at low or even negative interest rates is one that the Scottish Government should take advantage of through the UK Government borrowing in that way.

**The Convener:** Do you have anything to add, John?

**John Cullinane:** I have nothing further to say on borrowing.

11:30

**Angela Constance:** I was hoping to get a more reflective response on the need for Governments at all levels to be fleet of foot. The committee has received evidence about the need for greater access to the Public Works Loan Board and the need to look at other powers that will enable quicker responses. David Phillips said:

“There is a need to develop, cost and announce new measures very rapidly”,

as opposed to having to wait. Sometimes, given local circumstances, people want to lead as opposed to being led. That is my final point.

**The Convener:** Was that a question or just a comment?

**Angela Constance:** I suppose that it was more of a comment.

**The Convener:** Okay. I just wanted to be absolutely clear.

**Murdo Fraser (Mid Scotland and Fife) (Con):** I have two questions that, initially, I will put to Jim Gallagher. The first is about the Barnett formula, which you mentioned in passing a moment ago. We will hear from David Phillips from the Institute for Fiscal Studies shortly. In his submission, he says that there might be a case for “bypassing the Barnett formula” and using a needs-based approach for the allocation of funding if there are different impacts from Covid-19 in different parts of the UK.

I am interested to get your take on that, specifically in the context of the wider debate about the Barnett formula. We know that, for years, politicians in Wales and the north of England have argued that the Barnett formula is far too generous to Scotland, and that they would grasp the opportunity to have it reviewed. Would the approach that David Phillips proposes have a short-term attraction but, in the long term, prove

very dangerous in relation to the funding support that we in Scotland currently receive through the Barnett formula?

**Professor Gallagher:** Many years ago, I proposed the foundation of a small society called Friends of the Barnett Formula. I offered to be the honorary secretary, and I thought that the other member should be the Chancellor of the Exchequer, whoever he or she was. I proposed that society largely for domestic Scottish reasons.

The Barnett formula produces a devolved budget in Holyrood that is 25 per cent or more higher, per head of population, than the equivalent spending in England. As a former public official like yourself, convener, I spent a long time trying to find arguments to give to the Treasury that our level of expenditure was justified by our need. It is difficult to sustain those arguments when we are spending 25 per cent per head more in Scotland than in England. At a purely tactical level—for Scotland’s interests—I think that we should give a high priority to retaining the benefits of the Barnett formula.

Substituting a needs assessment for Barnett would not be to Scotland’s advantage. It might be fairer across the UK and more intellectually coherent and justifiable, but it would not be good for the budget that this committee considers. When I read the submission from my colleague David Phillips, whom I respect greatly, I thought that, if I was sitting where he was sitting, I might say what he is saying, but I am not and I do not.

**Murdo Fraser:** That is a very clear response.

I have a separate question about the fiscal framework. In your submission, you make the interesting comment that

“The mechanism for transferring income tax risk is ‘per capita indexation’”,

which was built into the original fiscal framework at the request of the Scottish Government in order to protect the Scottish budget from the risk of lower population growth in Scotland compared with the UK average. You make the point that that is

“hard to justify in principle”,

but you go on to make the interesting comment that

“expectations of relative population growth may be changing, and so might the views of the Scottish government.”

Will you expand on what you mean by that?

**Professor Gallagher:** I was hoping that somebody would take that bait. The argument for per capita indexation of the block grant adjustment in the fiscal framework is the Schleswig-Holstein question of Scottish politics. Of the three people who understand it, I might be the one who has

gone mad. The critical thing is that it means that the risk of relative population growth is not transferred to the Scottish block. I do not think that that is fair, because relative population growth determines the need for expenditure. I do not think that it is fair, but I can see why the Scottish Government argued for it. I know that the Treasury was not very happy at the time, because it did not think that it was right.

However, two things have changed. One is that the Scottish population has perked up rather. I rather suspect that post-Covid and perhaps post-Brexit, which is something that we have not yet discussed, UK population growth might not be quite so lively in future, so this might not be quite such a big issue.

The fiscal framework is due for review at the instance of the Treasury, five years after it was agreed. There are things that the Scottish Government might want from that review as a result of Covid, such as some kind of short-term easement of the unexpectedly large drop in stamp duty land tax. It might even want to argue for postponement or easement of the big overhang of income tax overestimation that will face us in 2021, when it might not be a good time to have a counter-cyclical cut in public expenditure.

The Scottish Government will be going to the Treasury and asking for things. In my experience of negotiations with anybody, but especially with the Treasury, if you ask for things, you might have to offer things in return. It might be that per capita indexation turns out not to be as big a problem as the Scottish Government foresaw five years back, so there might be some scope for negotiation there.

**Murdo Fraser:** Thank you, convener.

**George Adam (Paisley) (SNP):** As we come out of the crisis, we will be looking at economic recovery and at how that pans out. I agree with Professor Gallagher that the devolved nations and the UK Government need to keep the heid when we are having discussions on that. As most of the economic levers for recovery rest with the UK Government, that will be a challenge for everyone, because there will be a contrast between the challenges and priorities for the economy in Scotland and for the economies in other parts of the UK.

I would like to ask Professor Gallagher my question first and then go to John Cullinane. What are the challenges and threats to future funding for Scotland? How do we get around them so that we can work towards economic recovery?

**Professor Gallagher:** You are putting together two connected but slightly separate issues. One is the best approach to economic recovery, and the

second is what that means for public service funding in Scotland.

As for the former, you are right to say that the macroeconomic levers are largely in the hands of the UK Government. Given the integration of the UK economy and the fact that, on the whole, Scotland is, broadly speaking, in macroeconomic terms, around the UK average, it is not likely that the right set of macroeconomic responses at a UK level will be the wrong set of macroeconomic responses for Scotland. As a first approximation, that is probably right.

However, the microeconomic levers that we have, and which are mostly devolved, such as grants to businesses, training, physical infrastructure and so on, might well require different responses in Scotland.

Given the make-up of the Scottish economy—as I mentioned earlier, there is likely to be a larger dependence on leisure and recreation and on tourism—a different balance of responses will be required to support different sectors in different ways. The oil sector is another example. Detailed and substantial co-ordination will be required, which takes us back to the earlier questions about intergovernmental mechanisms and the need to make them work better.

As for public spending, my answer is, in a sense, the same answer that I gave to the previous question: please keep hold of Barnett, for fear of finding something worse. It produces for the Scottish budget 25 per cent per head more expenditure in Holyrood than is spent on comparable services in England. That is a huge advantage, which we must try our very best not to lose.

There are difficult questions coming. All borrowing is simply taxation transferred to the future. In the medium term, the tax burden—if one thinks of it as a burden—in the UK and the Scottish economies will be higher, because we will have to pay back at least some of the money that we have borrowed. UK taxes will be higher, and Scottish taxes may well have to be higher, too—whether that means local taxes, Scottish income tax or the other, minor devolved taxes—because, over the next five years or so, the public sector will be a larger part of a slightly smaller economy. Does that answer your question, Mr Adam?

**George Adam:** Yes, that is helpful.

**John Cullinane:** The position with the devolved tax regime is that very substantial amounts of Westminster taxation still apply in Scotland, while the extent of devolution has brought about Scottish powers and the scope to exercise those powers. Many of the stresses and strains that apply to the UK system are therefore still with you; I pointed previously to the stress and strain around

the very different treatment of incorporated and unincorporated businesses, and there is a similar, related fault line between the treatment of employed and self-employed people.

We can see how those fault lines have come to the fore in the current crisis. When the Chancellor of the Exchequer introduced the job retention scheme—the furlough scheme for employees—there was immediate pressure on him to do something similar for the self-employed. A support scheme was announced quite soon afterwards, but that posed a much bigger challenge to the UK Government.

Indeed, the category of those who have been left out of both schemes includes precisely those businesses that chose to incorporate and are now suffering from the effects of the virus. The amount of support that they can get is very limited, which simply reflects the speed with which the schemes had to be put together and the difficulty of acting with the same speed in respect of that part of the population. All those fault lines are UK-wide, and they impede economic recovery and impact on the resources of both Governments to deal with the situation.

There is also a Scottish dimension through what you try to do with your tax system—for example, by adopting the Adam Smith principles, including the ability to pay. One example is the very progressive rates for land and buildings transaction tax, which were mentioned previously. There is a question mark around whether, when you apply principles such as the ability to pay, you should try to do so in each particular chunk of tax, or tax rules, over which you have power, or whether you should step back and consider the best way to reflect that in the system as a whole without necessarily pushing each principle as far as it will go in the context of each tax.

11:45

As it has turned out, there is at least an issue in that regard as to whether that has something to do with the shortfall in revenues. Ultimately, if you push up tax rates, you always have to look at how taxpayers will react. At the end of the day, it is much easier for people to forego transactions in the housing market than to forego earning an income, for example.

The trade-off between how far you can push the principles and what is practical, and whether there is behavioural push-back, is possibly different in different parts of the tax system. One lesson that applies locally concerns whether it makes sense to apply those principles to the system as a whole rather than to look at each particular tax in isolation.

**George Adam:** Last year, Professor Gallagher brought out a paper titled “Progressive Federalism—A Different Way of Looking at the UK”, which was about creating a more progressive Scotland. Things have obviously changed and moved on, given the Covid crisis. However, you referred in your paper to empowering UK nations and regions in order to create that progressive Scotland. I am trying to work that out. Is there not an argument, as we look at economic recovery in Scotland, that we should look to empower UK nations and regions so that they can deal with the situation in their area using the extra powers?

**Professor Gallagher:** That is a good and very fair point. My view, which is not related especially to the Covid crisis, is that there needs to be a bit of rebalancing of the powers for all the devolved regions across the UK, including the regions of England, so that the UK becomes a bit more federal.

I am delighted that George Adam has read my paper. He will remember the list of powers in it, most of which were constitutional rather than fiscal. As it happens, it includes the idea that there might be capacity for the devolved Administrations on devolved matters to enter into concordats or agreements with the European Union.

I think that we should pursue that set of ideas anyway—it is not really a set of fiscal ideas. The important aspect is the embedding of devolution in the UK’s hideously unwritten and untidy constitution.

**George Adam:** I have one final question for both witnesses. Is there not the potential for a double whammy in Scotland as we move forward? I will explain. The first part is that the reserved function is not providing adequate support for the Scottish economy—I know that some members might disagree with that. There may be a conflict with the idea of support for the Scottish economy. The second part is that there could be higher block grant adjustments in future, which could have an effect on our budgeting. What is your opinion on that? Is there a potential double whammy for Scotland?

**John Cullinane:** I am sorry—I am not totally sure that I understand where the double whammy comes in. It is clear that there will be very difficult problems to deal with—

**George Adam:** I am trying to say that some of the reserved functions may not be what Scotland needs for economic recovery, which would have an effect. That would be the first part—because the UK Government will be looking towards UK needs, there could be conflict. The second part is the effect of higher block grant adjustments in future, which would affect our budgeting as well.

**The Convener:** I think that George Adam is saying that, if the measures that are taken by the UK Government create greater economic activity in the rest of the UK compared with Scotland, that might well have an impact on the BGA later—

**George Adam:** Yes, that is what I said, convener.

**The Convener:** Does that help?

**John Cullinane:** Yes. I guess that the extent to which that happens depends on the extent to which the actions that are taken by the UK Government have an unfavourable differential effect in Scotland. In other words, what matters is the extent to which the Scottish economy is affected more than the rest of the UK's economy and whether that is properly reflected in what the UK Government is doing. At the moment, I am not sure that I see that differential.

Obviously, our expertise is on the tax side. However, as I mentioned earlier, I can see that there are gaps in the income support levels, which I think are reasonably explicable by how quickly those schemes needed to be put together to ensure that help was available rapidly. I can definitely see those gaps affecting people in Scotland, but I cannot see a differential effect in what I have been able to identify so far, to be honest.

**Professor Gallagher:** I am reminded of the saying that, if we had ham, we could have ham and eggs, provided we had eggs. What I mean is, if two things that might happen happened, they would both have happened.

In macroeconomic terms, Scotland is broadly typical of the UK. It is about the third or fourth—I think the fourth—richest region in the UK, and, typically, Scottish macroeconomic variables are around the UK average. There is no a priori reason to assume that the UK's macroeconomic responses would be any better or worse for Scotland than they would be for the UK as a whole. Obviously, it is important to remember that, when we talk about the UK, we are talking about a country that includes Scotland; it is not a different country from Scotland.

It is important to look not at the potential differential performance of the Scottish economy in the future but at the actual differential performance of the Scottish economy in the past decade or so. That is what is striking. It has been consistently negative. In the past 10 years, we have done less well in promoting economic growth than the rest of the UK has. That contrasts with every decade before then, from the 1960s onward. In the 1960s, Scotland was one of the poorest regions in the United Kingdom.

At the time of devolution in 1999, Scotland was the third richest region of the United Kingdom. Since about 2008 or so—depending on what sets of numbers one looks at—per capita economic growth in Scotland has consistently underperformed that of the UK. In the decades before that, it consistently outperformed that of the UK. Rather than wondering what bad things might happen, it might be better to ask ourselves why it is that we have not done better over the past decade or so?

**The Convener:** I will move on, because we face a bit of a challenge in time terms. Alex Rowley will ask the next question.

**Alex Rowley (Mid Scotland and Fife) (Lab):** It strikes me that the level of uncertainty is high and that there are a great number of unknowns. As George Adam mentioned, as we begin to come out of the crisis, we will still very much be in it, and most people in the medical profession reckon that we will see a second wave of the virus. Professor Gallagher, given that we have that level of uncertainty and bearing in mind the £600 million budget gap that exists in 2021-22—goodness knows what else we might face as we move into next year—what are the options for the Scottish Government? What powers can it look at using? You seemed to rule out additional borrowing.

Sitting alongside that, a number of people, including yourself, have said that Scotland could be isolated from an economic crisis because of our large public sector. However, as we saw during the global crisis and the austerity that followed it, we could be more vulnerable if there is an austerity agenda that brings massive cuts in public services and jobs. What are the options for the Scottish Government in terms of the budget gap and our overreliance on the public sector?

**Professor Gallagher:** Those are really difficult questions. First, I will focus in detail on the Scottish budget. How the fiscal framework is designed is advantageous to the extent that it gives the Scottish Government spending certainty in each year. We do not find ourselves in the current year facing budget reductions because tax has gone down. We need to keep that aspect.

Alex Rowley rightly refers to what I call the income tax overhang, which is a problem. Absent a crisis, the Scottish budget would simply have to deal with it—and doing so would be very painful. Present a crisis, and given, as I said earlier, that the argument against having a counter-cyclical reduction in expenditure in the middle of a crisis is quite strong, St Andrew's house has a good argument for asking the Treasury for some flexibility. As I said in my answer to Murdo Fraser, the Scottish Government might have to give up something in return for that. It might have to

negotiate around the fiscal framework to get that capacity.

To be fair to all Governments worldwide, nobody is talking about austerity yet. We will have to pay back the borrowed money at some point, but I hope that nobody is thinking of cutting expenditure to pay it back any time soon because the counter-cyclical effect of that would be very bad indeed.

**John Cullinane:** I remember well the debates about austerity that took place after 2008 and 2010. At one time, there was almost a press and media frenzy in favour of austerity at the UK level.

This time, the preponderant balance of opinion seems to be much more in favour of letting the economy recover. Indeed, we are regularly hearing calls for tax cuts. I do not know how realistic all those calls are, but the balance of political and media comment seems to be very different now to what it was then. Indeed, earlier this week, three former UK Chancellors of the Exchequer—Alistair Darling, and two of his successors—gave evidence to the UK Treasury Committee, and there was a surprising degree of unanimity among them in saying how important it is to not harm the recovery before we make adjustments. For what it is worth, there is some apparent difference in the climate and the balance of people's comments.

**Alex Rowley:** Given where we are with this crisis, what are the opportunities for looking at other sources of income and revenue? Not everybody has done badly out of this. We have a massive Amazon operation down the road from me in Dunfermline, and Amazon has certainly done well out of the crisis. I remember that a previous Government introduced a windfall tax on utilities. Will there be an opportunity for a wealth tax? What options does the Government have?

*The Herald* this morning reports 25,000 job vacancies in the economy across Scotland. However, many of those vacancies are in areas such as health, social care and education; there have been massive declines in retail, entertainment and hospitality. What is the role of the state in looking at where the economy is shrinking and at intervention through reskilling and training? Do we need a different type of economy, and what is the role of the state in getting people prepared for that?

12:00

**John Cullinane:** In terms of Scotland's powers over tax, income tax is the biggest issue. Clearly, there are limits to what one can do. If we look back over history to big debt spikes and what has been done about them—even if we just take the four examples of the Napoleonic war, the two world wars and the financial crisis—we can see that

there have been radically different ways of dealing with them each time, including new levels of tax and new approaches to tax. I agree that a big political debate will be occasioned by the level of debt coming out of the crisis.

**Professor Gallagher:** Alex Rowley raises an important question about what happens in the long term. We will move to a world in which the economy is a bit smaller and the state is a bit bigger. The state will be bigger because it will do more things. It will do more on the provision of health; it should also, in my view, do more and spend more on the provision of social care, which is an issue that has been thrown into awful relief in the present crisis. That means more taxes. Quite a lot of those will be UK taxes, which is good news for Scotland, because the UK tax base, on the whole, is slightly stronger than the Scottish tax base, so we will get some of the side benefit of that.

If there are income tax rises in England, there will be pressure under the fiscal framework for income tax rises in Scotland. However, we have other options in Scotland. The first involves local taxation. The absence of council tax reform over the past 20 years is scandalous; it is appalling that we are still using 1991 house values. The persistent unwillingness to grasp that nettle is deeply problematic. There are some opportunities there, particularly because a tax on physical property is the nearest thing to a tax on wealth that exists in the UK.

The Scottish Parliament also has the power to create new taxes if it wants to. It could think about inventing one-off or consistent new taxes. After decades in which most of our political parties have been determined to make stuff free and deliver public services without charge, perhaps most awkward of all is the question whether it is actually wise to refuse to take the contributions of those who can afford to make some contribution towards the cost of the services that they get. There are options on the table, but none of them is at all easy.

**Alex Rowley:** In the paper that the Scottish Government published this week on Brexit, its analysis is that if we end up with a no-deal Brexit, or something close to that, without close alignment to the customs union and the European market, that will add massively to the economic crisis that we are facing. What are your thoughts on that?

**The Convener:** That is a good question, but I am conscious of the time. Before we go to the answers, I ask people to try to tighten up the questions and answers a wee bit. I know that that is a bit unfair on members who have still to ask questions, but if the witnesses could do their best to be as succinct as they can be, I would be most grateful.

**Professor Gallagher:** I will just say very briefly in response to Mr Rowley's question that adding further economic disruption on top of the economic disruption caused by the Covid crisis by driving towards a hard Brexit in the hope that it will somehow be disguised by the Covid crisis would be not just unwise but wicked.

**The Convener:** I give a heads-up to broadcasting that, after we have heard from John Cullinane, I will go straight to John Mason.

**John Cullinane:** I have nothing to add.

**John Mason (Glasgow Shettleston) (SNP):** Are you hearing me, convener?

**The Convener:** Yes.

**John Mason:** On the whole, income tax does not affect us immediately, but there is the related issue that, if Westminster departments find money in place of consequential, that could hit within the year. Is there a danger of that? We already seem to have had—[*Temporary loss of sound*—]of consequential being indicated, but then we are told that we will not get them because the money is from within the Westminster department. Is that a risk for us?

**The Convener:** Who is that question for, John?

**John Mason:** John Cullinane mentions the issue in paragraph 3.6 of his submission.

**John Cullinane:** I did not hear the question very well. However, when there are differential effects or differential decisions, there can always be anomalies within the formula. There can be swings and roundabouts but, overall, I agree with what Professor Gallagher said about the big picture on the Barnett formula. It is clear that there are particular risks when particular decisions are taken or particular developments take place and the adjustment works disproportionately.

**Professor Gallagher:** I do not think that there is a big risk here. There is sometimes what we might call a bit of noise around this, as people get the wrong end of the stick. As far as I can see, the Treasury has been punctilious in its calculation of Barnett consequential, including consequential in-year, partly because it gets a terrible amount of grief if it does not do the calculation properly.

An interesting issue that I suspect will come up, on which the committee might want to reflect, is the pressure that I think will emerge for the Scottish Government to spend Barnett consequential on the places that generate them, rather than spending them where it likes, as the rules allow. Health is an obvious example. I expect that there will be substantial on-going increases in the health budget in England, which will produce substantial consequential for the Scottish block. There will be no formal hypothecation of those,

because there is no such process under Barnett, but the committee might want to consider whether it would strongly encourage the Scottish Government to invest in health, which it has been less successful in doing over the past decade.

**The Convener:** I apologise to John Mason, but I have a quick supplementary on that last point about health. It is my understanding that all the consequential that the Scottish Government has received with regard to the health budget have been passed on. Is that not the case?

**Professor Gallagher:** I could bore for Britain on that issue, but the answer is no. If we look over the decades, we can see that if, since 2011, the health consequential had gone to the NHS budget in Scotland, the health budget would have been about £1 billion a year higher than it currently is. Some of that was diverted into free personal care and some of it was diverted into other priorities, such as policing, but it did not go to the NHS.

**The Convener:** I am sorry for interrupting.

**John Mason:** That is fine, convener.

Despite the answers that have been given, I still have concerns that there is uncertainty around some of the consequential. If they do not match what the Scottish Government is expecting in the current year, it will have to try to do something to match them. Can either of our witnesses suggest how the Scottish Government might do that, other than by getting more borrowing powers?

**The Convener:** Perhaps Professor Gallagher would like to pick that up.

**Professor Gallagher:** I am not absolutely clear about the assumption underlying that question, which is that if the Scottish Government expects to get something in-year—as a bonus, as it were—but does not get it, it would then have a problem. I think that it would merely have overestimated the amount that it would get.

One of the disappointments over the handling of the fiscal framework was that, perhaps not unexpectedly, the Scottish Government has not built up a cash reserve to deal with contingencies on anything like the scale that it might have done. If it had, it might have been easier to deal with a problem of the kind that Mr Mason anticipates, were that to happen. However, I do not know that it has happened.

**The Convener:** Yes, but there is also political reality in all of that, as can be seen from the pressure from the Opposition, as well as Government back benchers, on the Government to spend every available penny on public services.

I want to move on, but first I ask John Mason to confirm whether his question has been covered.

**John Mason:** Yes—that is fine, convener.

**The Convener:** In that case, we will move on to a question from Alexander Burnett.

**Alexander Burnett (Aberdeenshire West) (Con):** So far, much of the discussion has been about the relationship between the UK and Scottish Governments, but in your submission, Professor Gallagher, you touch on the revenue position of local government. You also mentioned local taxation in answer to Alex Rowley. What challenges for local government do you see there? More importantly, what might be the solutions to those challenges? I note that you have already commented on the valuation roll being out of date.

**Professor Gallagher:** Thanks, Mr Burnett. I am, as they say, glad that you asked that question.

Local government has been very much the poor relation of Scottish public finance for a long time now. It has had its fiscal autonomy systematically reduced and constrained, and its funding has been more squeezed over recent years than the Scottish block as a whole. It therefore starts from quite a difficult place.

Two issues are particularly difficult just now, the first of which is the funding of care for the elderly. I am not making a partisan point here; I think that we can all see that, collectively, we have neglected the care sector. We will have to rectify that issue, which has existed for a very long time.

As for local government more generally, I am quite concerned about the potential loss of revenue—especially in areas such as leisure and recreation, which depend substantially on people paying their money at the swimming pool, gymnasium or entertainment venue and so on. For reasons largely connected with value added tax, such services are often provided through arm's-length trusts or similar bodies. That could put substantial pressure on council budgets at a time when they will not have any money. There is no doubt that that could therefore create further demand on the Scottish Government.

In the medium term, we need a reformed and more effective system of local taxation that will actually raise more money. Council tax is anything but a perfect tax, but it is the one that we have. We have squeezed it hard for a very long time, which has left councils in a bad state.

Convener, I know that you have experience of being a council leader. Councils are very good at managing their budgets—they have had to be—but we cannot go on like this indefinitely. We need to give them more tax capacity and probably more actual support, particularly in health and social care.

**Alexander Burnett:** I have the same question about local government for John Cullinane. More pertinently, however, you mentioned that there is a

low level of awareness in Scotland of the fiscal framework. The Chartered Institute of Taxation's "primary purpose is to promote education in taxation".

How successful are you in achieving that?

12:15

**John Cullinane:** Clearly, we have a long way to go in Scotland and in the UK as a whole. We have quite a complicated structure of tax to deal with, I have to say.

**Patrick Harvie (Glasgow) (Green):** Good afternoon. There has been a lot of talk about uncertainty. Uncertainty is nothing new. We have always to set budgets and plan for the possibility that we might have to face a crisis; so, in some ways, we now have more certainty, knowing that we definitely have to face a crisis.

What further measures do the witnesses anticipate coming from the UK Government in the provision of a recovery package? Jim Gallagher has talked about the prospect of higher taxation and more borrowing at current cheap levels. The prospect of money creation in a recovery stimulus package is also part of the picture that many Governments around the world are looking at, as may the UK Government. To what extent would that flow through to additional flexibility for the Scottish Government—or would we simply have to accept that all the control would stay with the UK Government?

How does that fit with the tax picture here? I am pleased that Jim Gallagher has talked so much about the long-standing failure of the Scottish Parliament and Scottish Governments to reform the local taxation system, but is there still an opportunity to do that in the current context? Is it possible to deliver the kind of reforms to local taxation that could, for example, achieve a more effective wealth tax as well as higher tax revenues? Alternatively, have we missed the boat? Have we missed the opportunity to do that work, given the scale of political response that is focused elsewhere?

**John Cullinane:** To my mind, so far, the UK Government has responded with more largesse than one might have anticipated—given past crises and its past track record—first, in the level and speed of income support and, secondly, in the extent to which it is looking at winding that support down very gradually and putting a premium on keeping the economy going, not on withdrawing that support subsequently. As I mentioned earlier, the balance of political and media debate seems to be much more in favour of measures to keep the economy going instead of giving early priority to the fiscal problems that will arise.

One cannot read into that anything particular about the greater autonomy that might be agreed with Scotland. It might just be that one would hope for more of those favourable consequentials, because some decisions at Westminster will either directly affect Scotland beneficially or create favourable consequentials. The jury is out as regards negotiation.

On new taxes, I agree that nothing much has happened about council tax here. It is not that different from the situation in England, to be honest. One of the difficulties about grasping that nettle is that council tax is one of the few taxes that the ordinary person actually physically pays, as a discrete and chunky amount, rather than its being withheld from them at source or wrapped up in something larger. It has always been more visible and more subject to popularity issues. Nevertheless, the nettle has to be grasped.

On wealth taxes, which have come up a number of times, a view has grown up that, other than on property, it is very hard to contemplate those things. There has been a trend of moving away from wealth taxes internationally, most recently in France. There is a bit of a view that the wealthy are so mobile that there is not much that you can do about it. On the other hand, we see unprecedented levels of co-operation and exchanges of information between tax authorities, even when Governments have different political stances. Some of the views on why wealth taxes are not possible or feasible might need to be revisited, given that this crisis is affecting very many countries and there has been probably more global co-operation on tax than there has ever been before.

**Professor Gallagher:** I very much agree with John Cullinane on the UK Government's actions. The extent to which the UK Government has spent money has probably surprised the Government itself. By international standards, the interventions are very large.

You asked us to forecast what is coming. The interesting thing is how this level of debt will be managed and repaid in due course. I think that we will see a mixture of things. There is no doubt that we will see a mixture of monetary policy interventions—they have already started, actually. Those monetary policy interventions will end up with the Bank of England buying some of the UK Government's gilts in order to buy corporate bonds and so on. That will, in effect, monetise the UK's debt. Some of it will go that way.

There is a risk that some of it will go through inflation. The monetary regime might stop that, but, traditionally, that is an obvious response to high debt. Some of it will go on higher taxes and some of it will go on windfall taxes—of course, if I could tell you what those will be, I would not,

because people would then hide their money and not pay them. When you are using a windfall tax, you have to be quick. Some of it will have to be sustained, on-going taxation to support both the repayments and the continued increase in public service spending that is expected as a result of the crisis.

The big financial question is what microeconomic mechanisms the UK Government will use to support and intervene in individual companies. A lot of companies are on life support just now. They are living on Government loans, their staff are furloughed and their prospects are not great, particularly if the sectors that they are in are already adversely affected. I would not invest in a pub or a nightclub just now, because they are not going to be very busy for a long time. We need to think through supporting those who can be supported and reallocating that resource from people who work in those areas to other areas of the economy, some of which will be in the public sector.

As I said in my note to the committee, the immediate challenge for the Scottish Government is to get as close as it can beside the UK Government, to understand and influence its thinking so that there can be a co-ordinated response through agencies such as Scottish Enterprise and the new Scottish national investment bank, along with the UK Government's approach. None of us yet knows what the approaches will be.

**Patrick Harvie:** The other question that I want to ask is on the extent to which the Scottish Government has the ability to ensure that the recovery is equitable and socially just and that it results in a more equal rather than less equal economy.

We have already heard the argument that principles such as the ability to pay should apply to the tax system as a whole, rather than to each individual tax. That would imply the need to reverse the long-standing injustice whereby lower-income people pay a higher proportion of their income in overall tax than the wealthier part of society pays. We have had the example of tax-motivated incorporation, which is an option that is mostly available to people who have higher-than-average income and is available to very few lower-income people. That is an anomaly in the current system that benefits the well-off at the expense of everybody else.

I am looking for the witnesses' view on the extent to which the Scottish Government has the ability to ensure that we are protecting lower-income people, women, marginalised communities and younger people, who have borne the brunt of the economic impact so far. To what extent can we avoid that in the future recovery?

**The Convener:** If you could make your answers as succinct as possible, I would be grateful.

**Professor Gallagher:** Those are important questions. The biggest shift that will happen—the Scottish Government will play its part in this—is that the state will be a bigger share of the economy, and, by and large, activity by the state promotes more social justice than activity by the market. That, in itself, should help with the issues that Mr Harvie raises in his perfectly valid points.

**John Cullinane:** As Mr Harvie said, I mentioned the different treatment of incorporated and unincorporated businesses, which is something that could be looked at. Professor Gallagher mentioned local authority financing as well, so there are examples that could be looked at fairly early on. No doubt, there will be more, but there are things that could be addressed.

**The Convener:** I thank our witnesses very much. We have been asking you questions for an hour and a half, and I am very grateful for your input.

I will suspend the meeting for five minutes to allow a changeover of witnesses for our second session.

12:27

*Meeting suspended.*

12:35

*On resuming—*

**The Convener:** I welcome our second panel of witnesses: Mark Taylor, auditor director at Audit Scotland, and David Phillips, associate director at the Institute for Fiscal Studies. I warmly welcome Mark and David to our meeting and thank them for their submissions.

I remind members and witnesses to keep questions and answers as succinct as possible, because of the time, and I remind members that, when they put a question to the panel, they should identify who it is for first, as that will help our broadcasting team.

**Donald Cameron (Highlands and Islands) (Con):** In your submission, David Phillips, you make reference to a forecast reduction in funding of approximately £600 million in the coming years, due to various reconciliations. Is it fair to say, as I think you do, that as a result of those reconciliations and wider budgetary decisions taken by the Scottish Government, the maximum borrowing limits were exceeded even before the pandemic?

**David Phillips (Institute for Fiscal Studies):** Yes. In principle, the Scottish Government has

access to £600 million a year of borrowing for forecast shortfalls or outturn shortfalls in revenues. However, the full £600 million is only available in the case of a Scotland-specific shock, which is when the Scottish economy grows by less than 1 per cent and by 1 per cent less than the economy of the rest of the UK.

It is quite likely that the Scottish economy will grow by less than 1 per cent, but it is not clear whether it will grow by 1 per cent less than the rest of the UK. If that is not the case, the Scottish Government cannot access the additional borrowing that a Scotland shock would allow and borrowing is capped at £300 million.

The Scottish Government can also draw down approximately £150 million from the Scotland reserve. That would mean that there was a shortfall of around £150 million in the next financial year, related to the reconciliations of the block grant adjustments.

**Donald Cameron:** I am not sure how much of the previous session you heard, but Professor Gallagher was asked about borrowing powers and his view was that the question was premature. He gave reasons for that, which were that the UK Government has injected large amounts of money into Scotland, directly through the furlough scheme and indirectly through Barnett consequential. He also pointed to the ability of the UK Government to borrow at negative interest rates. Do you agree or disagree with that analysis?

**David Phillips:** The question of borrowing powers is not too premature at the moment. The borrowing powers were not designed to make up for long-term shortfalls or declines in Scottish revenues; borrowing is not an appropriate response to that.

A deterioration in revenues compared to forecasts, reflecting a long-term decline, is not what borrowing powers are for. The Scottish Government will need to make an adjustment to spending if its revenues are coming in consistently lower than forecast, and it will need to ensure that the forecasts are better in future.

The issue is not just about the potential economic effects of Covid-19 on tax revenues. Jim Gallagher is right that the furlough scheme will support tax revenues to an extent, and the large share of public sector employment in Scotland will also help income tax revenues to hold up reasonably well.

Borrowing does not always need to be used in relation to potential forecast errors in the impact of Covid-19 on the economy; it can also have a role in funding policy measures in the short term. One of the issues with the current regime is that it is not possible for the Scottish Government to fund

additional policy measures through borrowing, even in the short term.

If the Scottish Government wants to spend more on its response to Covid-19, and if the impact of Covid-19 is greater in Scotland than it is elsewhere in the UK, the Scottish Government does not have the option to borrow in order to fund such measures. It has to wait and see what funding it gets through the Barnett consequential. That might take longer, and the Scottish Government might consider that the funding is insufficient for the measures that it wants to take.

That is why, in my submission and in the publication that we issued at the start of the crisis at the end of March, we suggest that consideration should be given to temporarily relaxing the fiscal rules to allow the Scottish, Welsh and Northern Irish Governments to borrow not only in relation to forecast errors but to fund short-term spending measures.

A number of countries that are members of the Organisation for Economic Co-operation and Development, including Spain, have relaxed the borrowing rules for national Government. The OECD has suggested that it is worth while considering relaxing such rules in order to give more flexibility during the crisis phase as well as during the longer-term recovery and consolidation phases.

**Mark Taylor (Audit Scotland):** For reasons that the committee will understand, given my audit role I will avoid giving a direct view on what the measures and limits in the fiscal framework should be, but I will give a couple of observations about how the framework operates.

It is absolutely the case that, in the current environment, the uncertainties, volatilities and complexities relating to the Scottish budget that were beginning to come through as a result of the tax reconciliations and so on have been amplified very quickly. There is the issue of how the Scottish Government is able to manage that situation in the short term and as the effects play out in future years.

The borrowing powers are one option in the basket of measures that are available. The focus is often on how we can maintain our current spending plans in the new environment, which is understandable. Of course, the Cabinet Secretary for Finance is looking for additional flexibility and some certainty in relation to the funding that is available. Increasingly, however, there also needs to be a discussion about the way in which the budget is formulated and where the slack is, so that some activity can be turned down to accommodate new pressures. That design should be put into the budget, so that action can be taken more quickly.

I absolutely recognise the challenge in pulling back on expenditure. In the short-term environment, the summer budget revision shows that there are already examples of things that were expected to go ahead but which are not currently able to go ahead. That provides an additional degree of flexibility, because such funding can be deployed elsewhere. For example, there have unfortunately been some slight delays to the social security programme, but that has freed up some funding to be used elsewhere.

Inevitably, we will get into a period in which some tough decisions will need to be made on budget choices. Irrespective of the extent of flexibility that might be forthcoming, the Government will need to make those decisions in the short term as well as in the future. Clarity on that issue will be really important.

**Alex Rowley:** I have one question. Local government is on the front line. Councils were having to make major and difficult financial decisions before the crisis, and pressures are even greater now.

Audit Scotland tends to advise local authorities that they must have a certain level of reserves. Given the current situation, would you continue to insist that local authorities keep a certain level of reserves? What powers do you think local authorities could have—borrowing powers or other revenue-raising powers, for example—to get us through this next period of time?

12:45

**Mark Taylor:** I absolutely recognise the pressure in all public services—[*Temporary loss of sound.*]—at this time. I also recognise that the way in which local government finances work is somewhat different to the way in which the Scottish Government's finances work.

We have talked previously with the committee about the extent to which the Scottish Government is protected from changes in tax and income as a result of the way in which the block grant adjustments play through. To some extent, that is also the case for local government in the way that the Scottish Government underwrites non-domestic rates. A big form of local government funding is non-domestic rates, and essentially the Scottish Government covers the risk of the tax taking less than expected. We have seen in the summer budget revision how some of the funding that has flowed from the UK Government has been deployed to underwrite reductions expected as a result of NDR reliefs.

What is different is the extent of local government's reliance on income from charges. In the earlier part of the meeting, the committee heard about leisure facilities and the like. They are

more directly exposed and do not have the same kinds of buffer. Local government has the ability to deploy reserves that are kept for a rainy day, and it is certainly raining now. However, those reserves can be used only once, and they cannot be used to underpin on-going expenditure plans. There is a big challenge for local government.

Audit Scotland has never said what the right level of reserves should be. It recognises that that is a judgment for individual councils, and that will continue to be the case, but as part of councils' overall plans they will want to look at their options. Similarly, there might be a range of other revenue-raising options, none of which will be comfortable or straightforward.

Public services across the Scottish public sector will be facing tough budget decisions as a result of Covid, on top of what was already a tough environment.

**David Phillips:** I must admit that I know a little less about reserve levels and the revenue make-up of Scottish local authorities than I do of English local authorities, but I echo what Mark Taylor said about sales, fees and charges.

It is not just business rates that have a degree of protection, as there is a similar effect in the way that council tax is accounted for. There is what is called a collection fund and a general fund, and that means that the effect of any reduction in council tax receipts in the current year feeds through in a separate accounting exercise into the general fund for the next year, when councils have to update the amount that they have drawn down from their collection fund.

One of the interesting things that we can see in England is that the impacts of Covid-19 seem to be larger on the revenue side than they are on the spending side, at least in the current financial year. Perhaps surprisingly, it is not the most deprived areas that are likely to be hit hardest by the immediate financial effects of Covid-19; it is often the more affluent areas where councils raise more income through sales, fees and charges and council tax.

Again, perhaps surprisingly, although we know that people from lower income households are likely to be working in sectors that are most affected by lockdown and social distancing policies—hospitality, retail and so on—many of those jobs are concentrated in the less deprived areas that are often the nicer places for tourists to visit.

My point is that, in the short term, we might expect some of the hardest hit local authorities to be in the more affluent, less deprived parts of Scotland, which, traditionally, we worry less about. That is a pattern that I see in England. In the longer term, however, the parts of the country that

are more likely to be hit with the social and health impacts of lockdown—such as ill health, housing problems and mental health and safeguarding issues—will be concentrated in deprived areas, because those issues tend to be concentrated in deprived communities. We might expect there to be a bigger impact in more deprived areas later on, as those effects become more serious.

In England, we noted that, with regard to reserves levels, the authorities that look likely to be hit harder in the short term tend to have higher reserves. There could be some authorities that have large impacts on their revenues and costs but also low reserves. Again, we suggested considering the potential for short-term borrowing for resource spending, to go alongside the prudential regime that local authorities have on capital spending.

**John Mason:** I have a couple of questions about the submission papers. David Phillips, your submission says that Scotland received £3.5 billion but has passed on only £3.4 billion. Mark Taylor, the Audit Scotland paper says that Scotland received £3.6 billion but spent £4 billion. Those figures do not tie in with each other. Can David Phillips or Mark Taylor explain?

**David Phillips:** I took my figures from a Scottish Parliament information centre briefing paper, which was produced at the start of May, so the figures could have been updated since then. There have been small additional Barnett consequentials—for example, the additional funding for social care—and the Scottish Government could have announced other measures.

It would not surprise me if the Scottish Government has gone further than the Barnett consequentials. The Welsh Government announced additional measures on top of those that are funded by what it receives through Barnett; it has funded them by reallocating EU funds from business development to business survival and by deprioritising certain areas of spending that could not go ahead or would have had lower returns in the current environment—such as trade and investment promotions and road safety measures.

It would not surprise me if the Scottish Government, in announcing further measures, as well as using Barnett consequentials, has started to think about reallocation of resources, because that is also happening in England. Within the departmental budgets in England, there are reallocations as well as new money.

**The Convener:** To help David Phillips, a lot of reallocations and extra money were announced towards the end of May. Mark Taylor can pick up on that.

**Mark Taylor:** As David Phillips said, it is a timing issue. The figures that we have used are from the summer budget revision. That emphasises how dynamic the situation is and will continue to be. One of the features in the current environment is that, rather than having nice, clear-cut fiscal events at a number of predefined points in the year—difficult though that might have been in the past—there is much more of a running response. The same challenges that the Scottish Government has in managing its budget will be going on at the UK budget level, as well as in the interaction between the two Governments.

**John Mason:** Paragraph 26 of the Audit Scotland submission talks about the risk of “negative Barnett consequentials”. I asked the witnesses from the previous panel about that and they seemed to feel that there was not much risk within the year. However, I had the gut feeling that the Government was uncertain about how much would be coming in consequentials. There is therefore a risk that the Government might overcommit in the current year, in which case it would have to make savings in the current year. How big is the risk in that area? I ask that to Mark Taylor especially.

**Mark Taylor:** I certainly recognise that the risk exists. I said at the outset that increased volatility, complexity and uncertainty are playing through in the current year. Different judgments can be made on how that fits in the grand scheme of things, but it is absolutely the case.

We are in an environment in which the UK Government is also trying to manage its way through the situation. Earlier, the word “punctilious” was used in relation to how it is doing that; I recognise that, but things move around and change a lot, and we expect things to continue changing.

In the 2019-20 financial year, we were all a bit surprised by the downward shift in Barnett consequentials, but that is how Barnett works—it works both ways, on the basis of the budget adjustments that the UK Government makes. If the UK Government is funding additional spending as a result of Covid-19 from reductions elsewhere or activity that is no longer happening elsewhere, that will play through in the Barnett consequentials.

From the Scottish Government's perspective, the main challenge is understanding the uncertainty and doing what it can to eliminate it as far as that is possible. I understand the efforts that have been made in that regard. The issue is a feature of the current circumstances and is an example of how the uncertainty in the short term is playing through now.

**The Convener:** David Phillips has a short contribution to make on that.

**David Phillips:** If the UK Government were to say that some of the planned spending would be funded through reallocations rather than new money, one option would be for it to follow the approach that it took back in 2010, when it announced in-year budget cuts for UK Government departments but gave the devolved Governments in Scotland, Wales and Northern Ireland the option to defer those cuts to subsequent years. That could be an option again. If the UK Government decides to unwind some of the consequentials—I am not sure how high the risk of that is—it could allow the Scottish, Welsh and Northern Irish Governments more time to make those changes, as it did in 2010.

**Alexander Burnett:** I had intended to ask about the concerns about local government funding and possible solutions, but David Phillips gave an extensive response on that in his answer to Alex Rowley.

I would like to develop a point that Alex Rowley made about reserves. I suppose that this is more of an audit question. How financially secure are councils? Do they have some sort of credit rating? How do you monitor that? What state are councils in, financially speaking?

David Phillips might want to add to his previous answer, after which we can hear from Mark Taylor.

**David Phillips:** I do not know what level of reserves Scottish councils have. In England, councils have on average reserves of around 30 to 40 per cent of annual expenditure, which is a significant amount. Initially, the UK Government said that it would fund all the costs for councils. However, it has now looked at reserve levels and, because of the financial issues that it faces, has decided to let local authorities dip into their reserves to fund some of the costs.

Mark Taylor will have a much better idea of what the reserve levels of Scottish authorities are and of whether similar scope exists in Scotland.

**Mark Taylor:** That is a big question that requires a long and detailed answer, which, of course, there is not time for me to give. However, I can give an overarching view.

The Accounts Commission, which works alongside Audit Scotland in the area of local government, reports annually on the overall financial position of local government, and it will continue to do so. It will keep a close eye on that as the situation develops. The fact that the strains on local government are clear has been reflected in that reporting, and local authorities face significant additional challenges as a result of Covid. Public services in general will need to work their way through the implications. The extent of the challenges faced by local government and

public services more generally should not be underestimated.

Short-term funding can get us so far, but the overriding environment is one in which the extent of the strain on the public finances and the overall ability to manage that has been dialled up significantly as a result of Covid-19, and that applies to local government as much as it applies to the rest of the public sector.

13:00

**Angela Constance:** Can David Phillips explain how the lack of borrowing powers limits the Scottish Government's ability to respond effectively to a crisis such as Covid? He touched on that in his paper. Can he also explain how having more borrowing powers could help to support economic recovery? The paper also touched on how things could be different and made reference to practice in the OECD, and its suggestion to relax some budgetary rules.

**David Phillips:** Overall, the fiscal framework provides a lot of insurance for the Scottish Government's finances. That was covered quite extensively by the earlier panel, so I will not say much about it. However, a combination of block grant funding and adjustments provides a lot of insurance for the Scottish Government against falls in tax revenues as a result of the financial effects of Covid-19. The UK Government bears the cost of UK taxes, which account for more than half of Scotland's tax revenue. The fiscal framework and block grant adjustments mean that the impact on Scotland is delayed, and also that Scotland only bears the relative risk of it. A lot of support is provided via those mechanisms.

We have spoken about the extent to which the rules on borrowing to cope with forecast shortfalls in revenue are quite constrained, with the idea of a Scotland-specific economic shock playing a role. I think there is a case for relaxing those rules. We have seen that tax revenues in the UK do not only fall when UK GDP falls, especially if the impact of a crisis has a cost on the high tax-yielding sectors like oil and gas.

There is also a case for uprating the borrowing rules in line with tax revenue growth. Those rules were fixed in 2016, since when there has been growth in underlying tax bases that are actually indexed. Therefore, I think that changes need to be made there.

The biggest short-term issue in the current crisis has been that the borrowing powers are really for the purpose of forecast shortfalls in tax revenues or overspends on demand-led welfare measures, when those come in. The powers are not there to provide additional liquidity for the Scottish Government to take additional policy measures.

Therefore, it cannot use borrowing to fund additional spending or discretionary tax reductions as part of a fiscal stimulus.

I wrote an initial piece on all this back at the start of the crisis in March, when it was clear that there were some delays in the UK Government announcing its policies. When it announced them, that confirmed what the Scottish and Welsh Governments would get from the Barnett formula, which allowed the Scottish and Welsh Governments to announce some costings for their own measures.

At a moment of crisis, slowing down the decision-making process can lead to constrained and delayed responses, and certainly to political difficulties for the Scottish and Welsh Governments if their responses are seen to be lagging behind the response in England. However, there was only a lag because they had to wait for English measures and funding to come through before they could determine their own measures. In the short-term, additional borrowing powers to fund policy measures would avoid that problem.

It also relates to the fact that the Barnett formula is used to allocate additional funding from Westminster to Scotland. It is a population-based formula, but the impacts on Scotland, Wales and Northern Ireland might not be equivalent to their population shares. One option would be to reform the Barnett approach to reflect that, by bypassing the formula to give more needs-based allocations. The other option would be to give the Scottish, Welsh and Northern Irish Governments powers to borrow additional money if they want to respond.

There are two aspects to my response. In the long term, there is a need to consider the rules on the existing borrowing regime for forecast revenue shortfalls. They are not flexible enough and they need to grow in line with the tax base. However, the immediate issue is borrowing for policy measures, which is completely disallowed. I do not think that we want to rush into making permanent changes to the fiscal framework at a time like this. For example, the OECD and Spain are not doing so; they are putting such changes to one side for now and saying, "Look, given the current crisis, we can have some additional flexibility for this period."

It is worth our considering doing the same. To be frank, that should have been considered earlier—back in late March or early April—but it would still be worth doing now in case there should be a further wave of virus cases or other impacts that would require further policy responses.

**The Convener:** I am not sure whether David Phillips heard the previous panel's answers to our questions on the Barnett formula. Professor Gallagher said that we might expect some

commentators to want a change to the formula but that that might be dangerous for Scotland. I will just leave that there as a comment. Perhaps that is a bit wicked of me, but there you go.

**Jackie Baillie:** My area of questioning is largely the same as Angela Constance's. There will be immediate impacts on the budget in this year. The decrease in income from land and buildings transaction tax and the increase in expenditure in social security funding are just two examples.

I know that certain mechanisms are in place, but I wonder whether they are sufficient and whether there is sufficient headroom in Scotland's reserves and its borrowing. I ask Mark Taylor to respond to that first.

**Mark Taylor:** I start by recognising that the earlier witnesses discussed how our income tax arrangements mean that the hit from that—if there should be one—will be down the line. That will certainly be the experience in some areas of the budget this year. It will particularly apply to social security, because of the size of that budget—£3.5 billion—and the extent of uncertainty over the accuracy of forecasts in that area, given that there is no relevant data set. We have yet to experience how those forecasts will play through: we are at a very early stage in the current year, which brings a degree of risk to the process.

The risk on the tax side is slightly lower, given the relative size of LBTT. As Jackie Baillie said, the block grant adjustment mechanism provides a degree of dampening of whatever those effects might be. At the heart of how that operates is the relative impact between what happens in Scotland on social security and devolved taxes compared with their equivalents in England and Northern Ireland and what the relative effects are.

We have got into the habit of thinking of risk as being all one way—it is always bad, always down or always less, or it always costs more. However, in forecasting, risk can go either way. What the forecasters made of those numbers and how things have changed from there in both economies since then will be what plays through.

Ms Baillie's question was whether we have the powers and flexibility to deal with such a situation. It is difficult to get an overall sense of that. Others have talked about the degree of constraint around the aggregate effect of the reserves and the borrowing powers, which is absolutely a thing. However, we must recognise that some decisions made in previous years—for example, on when to borrow and what to do with reserves—also carry through to the current year and must be reflected in decisions made now. Similarly, things that the Government does now will carry forward into future years.

That is all very challenging. There is significant uncertainty, and much of the discussion has been about how the rules might be changed to accommodate it. Even if the rules are changed to a certain degree, I go back to my earlier point that a high degree of budget management will be required this year so that we can understand what can be spent, because the environment is very different, and what might be freed up around that. Equally, there will be some hard decisions to take down the line about priorities and recognising that, in the budget, it is a lot easier to turn certain things up or down than others. Some costs are really committed and some things are easier to control in the short term.

Increasingly, the discussion will be about that budget management and how those judgments are made. From our perspective, there is a real need for transparency around the effects of that management, as well as the judgments that the Government is making, and the committee and Parliament need the opportunity to scrutinise them.

**Jackie Baillie:** Thank you very much, that was a helpful response. I have a similar question for David Phillips. You talked about temporary relaxation of borrowing powers on the basis of policy delivery. However, is this not simply necessary for the current climate in which we find ourselves, just to manage what is going on?

**David Phillips:** In terms of the in-year risks through revenues, the Scottish Government has borrowing powers of £500 million for smoothing the timing of receipts and spending. Especially given the update to the block grant adjustment for the land transactions tax and the landfill tax in the autumn, it looks as though in-year borrowing powers will be sufficient for the risks there.

We need to address the question about the rules on borrowing for forecasts and revenue undershoots and shortfalls and so on. That is worth discussing, especially in the run-up to the renegotiation of the fiscal framework. However, it is my view that the biggest issue, and where the biggest constraint has been, is around formulating policies and policy responses.

The powers give better protection. It may not be perfect protection, but there is a high degree of protection for the economic impacts of Covid-19 itself on the budget; it was almost by design. The rules are basically designed to prevent the Scottish Government from taking a different fiscal stance to the UK Government—to prevent it from having a higher level of borrowing as a policy stance. That means that, at the moment, it can slow down the policy response. That is a more serious issue.

One issue that is worth talking about is that borrowing powers are never an appropriate response to a long-term hit to the economy. One of the quite strange features about the fiscal framework is that the way it was designed insulated or protected Scotland from any risk that its welfare spending was higher or its tax revenues lower at the point of devolution—the so-called no-detriment principle—so that any change in relative revenues or relative spending from that point on is purely borne by the Scottish Government. It has 100 per cent of the risk at the margin for changes in its relative revenue performance or changes in its relative welfare performance—that is all borne by the Scottish Government. That is quite unusual internationally and it might be worth considering whether that is appropriate.

I mention that because, for example, the Scottish economy could recover less quickly from Covid-19. There are some elements of the economy which suggest that that could be a risk, because of a higher reliance on hospitality and associated industries and a higher reliance on the oil and gas sector in particular. If the Scottish economy recovers more slowly from Covid-19, that would lead to on-going depressed revenues, which borrowing could never really cover because borrowing is for short-term falls in revenue, not for on-going falls in revenue.

It is worth considering whether the whole set of other fiscal rules needs to be considered at some point to bring it more in line with international norms where there is a degree of risk sharing between central and devolved Governments and all the idiosyncratic risk is not always borne by the devolved Government.

13:15

**Murdo Fraser:** I just have one question for David Phillips. It goes back to the point about the Barnett formula that was touched on just a few moments ago. In your written submission, you make a point about the UK Government potentially bypassing the Barnett formula if there is a differential impact from Covid-19. However, as the convener alluded to a short time ago, there are politicians in other parts of the UK such as Wales and the north of England who have always been unhappy with the Barnett formula and believe that it gives Scotland an unfair advantage over them on funding. Do you think there is a risk that the short-term advantage from bypassing Barnett might in the long run be to Scotland's detriment if that were seized on as an opportunity to replace it with a needs-based system?

**David Phillips:** The Barnett formula should be reformed in the long run, but one needs to distinguish between the Barnett formula and the level of funding for the different countries, because

the Barnett formula is not what determines Scotland's level of funding; it applies to the annual changes in funding. In the long term, the Barnett formula could be of detriment to Scotland because of what is called the Barnett squeeze, whereby the Barnett formula gives a population share of the increase in spending in England to Scotland, and to Wales and Northern Ireland, although Wales has negotiated an addition to that. Adding a population share each year can mean that the higher levels of spending in Scotland are slowly eroded over time because only a population share is added and not a needs-based share.

It is not necessarily the case that reform of the Barnett formula would cost Scotland; what would cost Scotland is if an assessment of the overall funding levels and not just the Barnett formula was carried out, because it looks like Scotland gets a somewhat higher level of funding relative to other parts of the UK. I suggest reforming the Barnett formula to make it more suitable, and looking at the funding levels; it is possible to distinguish between those two things.

As with the borrowing powers, it is possible to have rules that apply in moments of crisis. The Barnett formula has been bypassed in other cases when it has been deemed to be inappropriate, and that would be an option here. Politicians are better placed to answer whether that would affect the politics of the Barnett formula going forward and make it more likely that the whole structure of funding be questioned. The UK Government has already started to look at that question, and the negotiations with the Welsh Government on the fiscal framework for Wales were a precursor to reopening some of those questions in the Scottish fiscal framework negotiations. Whether that is already on the table somewhere is an open question.

**Patrick Harvie:** I will pursue the point that Murdo Fraser and David Phillips discussed. In the absence of a fully renegotiated and agreed reform to the Barnett formula or any other aspect of our fiscal relationship, is it not clear that a short-term bypassing of the formula would have to be done in a way that ignored any kind of principle of consent?

The most politically significant bypassing in recent years was when Theresa May's minority Government gave additional funding to Northern Ireland to secure a political deal with the Democratic Unionist Party, and that caused huge political controversy. If the UK Government was to do something similar here, unless it benefited only the devolved areas at the expense of England, which seems highly unlikely, it would have to be done against the express objections of devolved Governments. Would that not destroy any trust

and possibility for political co-ordination in relation to the difficult choices that lie ahead?

**David Phillips:** I would hope for a degree of maturity on all sides of that political debate. The scenario that I have in mind of where a Barnett formula bypass might be most warranted would be if there was a significant flare-up of Covid-19 in one part of the UK while the disease remained under control in other parts. The flare-up could be in one of the devolved nations or in a region of England. If it was in one of the devolved nations, under the Barnett formula, that nation would not get additional money unless the equivalent population share of money was spent in England, which could be substantially larger. If a region in England was affected by a flare-up, depending on the size of the region, the need to offer additional funding for the health service, local government and so on could imply more than equivalent money being spent in Scotland, Wales and Northern Ireland.

If there was a flare-up in Northern Ireland, I would hope that the UK Government would understand that there was a particular issue there, and I would also hope that the Scottish and Welsh Governments would understand if there was a particular issue in Yorkshire or greater London that required the formula to be bypassed. However, I understand that the fiscal frameworks and the rules around them are political.

Ultimately, I want the Barnett formula to be replaced by a formula that tries to take account of the differential needs of the different parts of the UK so that funding is not, in effect, an historical accident, as it is under the Barnett formula.

**Patrick Harvie:** I take the point about a potential localised flare-up. We probably do not have time to discuss the issue in depth, but it seems to me that, if a particular part of the UK was to re-enter lockdown, reinstating a furlough scheme for that area would be a much bigger cost than, for example, the immediate health costs.

Your submission touches only lightly on the devolved tax powers and options in Scotland. To what extent do we have the ability to use tax and other measures to prevent the Covid crisis and recovery from resulting in an even more unequal society? Do we have the ability to ensure that recovery closes the inequality gap in incomes and wealth or do we lack the powers that are required to achieve that?

**David Phillips:** The taxes over which the Scottish Government has powers are some of those that are most directly linked to redistribution. The income tax powers allow the Scottish Government to change the progressivity of the income tax system. The powers over property tax—especially council tax but also land and

buildings transaction tax—allow the Scottish Government to change the progressivity of those taxes. In fact, historically, the Scottish Government has made use of the powers to increase the progressivity of income tax and property tax.

There is a degree of flexibility in the existing tax regime to change the balance of taxation during the recovery phase. There are also powers to top up welfare benefits, if the Scottish Government wants to do that. At the moment, the Scottish Government does not have powers to decide to use the tax system to stimulate the economy. That is because of the borrowing rules, which effectively say that the Government can borrow only for forecast shortfalls and not for policy measures, and stimulus would be a policy measure.

There is a case for considering whether it is appropriate to allow that in the short term in order to reflect the different judgments in Scotland about the different circumstances in Scotland. However, on the possibility of that being opened up as a longer-term policy option, if there is one thing that the UK Government will stand on very firmly in the negotiations for the next fiscal framework, it will be the issue of allowing Scotland to take a different fiscal stance and, in effect, to borrow more in the longer term. In the short term, giving short-term powers to devolved Governments could be a way to use the tax system to find more stimulus.

**The Convener:** That concludes our questions. I thank Mark Taylor and David Phillips for their evidence. We have covered a lot of detail, and it is not always easy to do that in this virtual process, so I am grateful to everyone involved.

As we have no more public items on our agenda, I now close the public part of the meeting. I ask members to log on to our Microsoft Teams meeting to discuss our work programme in private.

13:26

*Meeting continued in private until 13:38.*

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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