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Finance and Public Administration Committee

Tuesday 6 December 2022

Session 6

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Pàrlamaid na h-Alba

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FINANCE AND PUBLIC ADMINISTRATION COMMITTEE

32nd Meeting 2022, Session 6

CONVENER

*Kenneth Gibson (Cunninghame North) (SNP)

DEPUTY CONVENER

*Daniel Johnson (Edinburgh Southern) (Lab)

COMMITTEE MEMBERS

*Ross Greer (West Scotland) (Green)
*Douglas Lumsden (North East Scotland) (Con)
*John Mason (Glasgow Shettleston) (SNP)
*Liz Smith (Mid Scotland and Fife) (Con)
*Michelle Thomson (Falkirk East) (SNP)

*attended

THE FOLLOWING ALSO PARTICIPATED:

David Phillips (Institute for Fiscal Studies)
Ben Zaranko (Institute for Fiscal Studies)

CLERK TO THE COMMITTEE

Joanne McNaughton

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance and Public Administration Committee

Tuesday 6 December 2022

[The Convener opened the meeting at 10:15]

Budget Scrutiny 2023-24 (United Kingdom Context)

The Convener (Kenneth Gibson): Good morning, and welcome to the 32nd meeting in 2022 of the Finance and Public Administration Committee.

Our first agenda item is an evidence session with the Institute for Fiscal Studies on the United Kingdom autumn budget statement and the wider UK context, with a view to informing our scrutiny of the upcoming Scottish budget 2023-24. We are joined remotely by David Phillips, associate director, and Ben Zaranko, senior research economist, at the Institute for Fiscal Studies. I welcome you both to the meeting.

I move straight to questions. Your submission states that the Office for Budget Responsibility notes that the UK's economic position with regard to fiscal policy has been beset in the past six months by

"a series of dramatic swings in the direction of fiscal policy with five major fiscal statements delivered by three successive governments"

and that

"the net impact of this series of announcements and reversals has been to add over £40 billion of borrowing by 2027-28".

What will the impact of that be on not just the UK economy but Scotland's economy?

David Phillips (Institute for Fiscal Studies): Ben, do you want to go first?

Ben Zaranko (Institute for Fiscal Studies): Sure. Thank you for having us this morning, convener.

The key thing that we need to emphasise in all this is that the UK has undergone an adverse trade shock that has made the country poorer. The things that we import have become more expensive, particularly gas and food, and the things that we export have not gone up in price to the same extent, which makes us a poorer nation. There have, of course, been various swings in fiscal policy—some quite dramatic ones—over the course of this year, but the fundamental thing is that whatever fiscal policy course had been taken, we would have suffered the same shock and we would have become poorer.

Looking into the medium term, I think that two key things come from the OBR forecast. The first is a deterioration in the outlook for growth and a weak outlook for the economy. The OBR is more optimistic than the Bank of England, but it is more middle of the pack when it comes to other independent forecasters. Secondly, the fiscal challenge of that weak outlook for economic growth is compounded by a large increase in how much we can expect to spend on debt interest as a consequence of higher inflation, particularly higher interest rates.

That combines to make the Government's public finance position worse on aggregate by something like £80 billion by the end of the forecast period. The Government has chosen to offset part of that through tax rises and cutting back on its spending plans, but we have just absorbed some of that and the Government has loosened its fiscal rules and is set to meet them by a hair's breadth. Things are highly uncertain but, as it stands, we are only just on course to meet those rules.

What that means for Scotland is probably several years of squeezed funding as inflation eats away at the real value of the public service budgets that have been set, and the grant funding that has been granted to the Scottish Government, combined with various tax rises. The Government essentially freezing every tax threshold in sight is an attempt to raise revenue that will exacerbate the challenges facing the Scottish Government, particularly in Scottish public services.

I will stop there. Does David have anything to add?

David Phillips: I think that Ben has said it perfectly. I am sure that we will come to this in a bit, but on the impacts on Scotland, I am sure that there was a slight loosening of the spending envelopes for the next two years. That will mean a bit more funding than was previously expected for the Scottish Government next year, although my back-of-the-envelope calculations suggest that, in 2024, although more money will come from the Barnett formula than the Scottish Government had built into its medium-term plans, the fact that the UK Government is no longer going to cut the basic rate of income tax in the rest of the UK means a higher block grant adjustment, which might more than offset the impact on Scotland.

From 2024 onwards, the Scottish Government will get less funding because of the potentially higher block grant adjustment and, beyond that, the tax and public spending envelopes. The people of Scotland will be affected by the economic downturn as much as the rest of the UK, one would imagine, and, at least in the short term, the higher energy costs will probably affect people in Scotland somewhat more given the colder weather and higher need for heating, especially during the winter.

Convener, on your point about the extent to which the flip-flopping around on policy exacerbated the economic outlook, to some extent that is a bit unclear. It was clear that the UK saw a bigger rise in interest rates than other countries in the aftermath of the mini-budget. That now seems to have largely disappeared with the reversal of those measures and a fiscal tightening. The question, then, is whether the fiscal tightening had to be a bit more significant than would have been the case in the absence of the flip-flopping and potential loss of credibility. However, as Ben Zaranko said, a substantial chunk of planned extra borrowing is being allowed to go ahead. The UK Government is planning to offset part of the weakening in the public finance position, and that might store up some problems for the longer term with a higher level of debt. As it stands, debt will fall very fractionally in the medium term whereas previous plans had been made for it to fall at a faster rate.

The Convener: We can all see that the plan is for the real impact of the budget to fall after the next UK general election. Do you disagree with the OBR when it says that these continual policy changes have cost £40 billion in additional borrowing? That seems to be the implications of your response, David.

David Phillips: I will hand over to Ben in a second, but I was not aware that the OBR had said that the changes in fiscal policy had led to £40 billion of weakening in the public finances. My understanding is that, while the OBR was doing its forecasts, higher interest costs were related to the somewhat reduced credibility of the UK's fiscal policy, but the main factor underlying it was the deterioration in the underlying economic environment.

The Convener: My understanding is that the figure came from Richard Hughes, the chair of OBR. We will move on.

You talked about growth. I was looking at *The Economist*'s review of 2023. As you will know, every year *The Economist* provides a number of forecasts, although they are not the kind of forecasts that we generally discuss—perhaps "predictions" is a better word—for economic growth and so on. It says that the UK will grow at -0.8 per cent next year, with a per capita income of $55,000 at purchasing power parity, whereas the Republic of Ireland will grow at 5.4 per cent, with a purchasing power parity per capita income of $135,000. Why is the UK in such a different position from countries such as Ireland, which is just next door?

David Phillips: There is a particular factor with Ireland's gross domestic product, whereby the activities of multinational companies such as Apple, Google, airline companies and others base their assets in or route their profits via Ireland, which leads to an overstatement of Ireland's GDP relative to that of other countries. The Irish statistical agency has produced another measure called the modified gross national income indicator, or GNI*, which tries to strip those elements out. That still shows Ireland as being better off than the UK, but it is not more than two times better off on that measure.

It is definitely the case that, relative to other northern and western European countries, the UK has poor productivity, and that has been a long-standing problem. We saw some reduction in that gap from the late 1980s to the late 2000s, but it has widened since the late 2000s. The precise reasons for that are somewhat uncertain, but a range of factors has been raised, such as low investment, especially business investment in fixed capital; relatively poor skills, especially core intermediate level skills; and issues around the property market and the supply of property. It is undoubtedly the case that, relative to its neighbours, the UK is a bit of a laggard in terms of productivity.

Going forward, the UK is one of the economies that is projected to do least well during the period 2022 to 2024. To some extent, that will be linked to our reliance on gas as an energy source, because the price increases have been particularly large, but other factors could be at play. For example, there is the on-going fallout from Brexit and the effect of historic low investment. There could be several factors underlying that prediction.

Ben might want to add some more to that.

The Convener: Ben, do you want to come in?

Ben Zaranko: Yes, and I would like to offer a response to your previous question on the £40 billion, convener. If I understood you correctly, that is the OBR's estimate of the fiscal tightening that the Government will do in 2026-27. That is relative to a deterioration in the forecast of around £80 billion, so the offset is about half of that, and the fiscal policy is going through about 40 per cent tax and 60 per cent spending cuts.

That is stated Government policy, which is fine, but there are questions about whether income tax thresholds can be frozen for that long or whether pressure will build for that policy to fall apart, so that tax rises actually have to go ahead. Also, will the Government be able to keep a lid on spending to that extent? Will it be able to get away with offering 1 per cent average real-terms increases in the face of substantial pressures on public services? If you think that spending plans will get topped up and a future Government will backtrack on some of the planned tax rises, that number could change.

I have one thing to add to David Phillips's answer about why the UK's growth outlook looks worse than those of other countries. Of course, trade has to be part of it. There are now clear signs in the data that leaving the European Union is starting to affect our exports, particularly of financial and other professional services. That is having a clear impact.

There is also increasing evidence that the health of the UK population seems to have worsened by more than health has done in other parts of Europe, and there is a bit of a puzzle around why that is the case. We can see it in disability claimant data, for example, or in the number of people dropping out of the labour force to become economically inactive. There are clear signs that the health of the population has taken a hit and that is feeding through to our productivity and economic fortunes.

The Convener: That is a good point. I understand that there has been a 600,000 increase in the number of people who are economically inactive relative to the number before the pandemic. I appreciate that that is an issue.

One of the things that has been predicted is a 7 per cent fall in living standards during the next two years. Obviously, the impact of that will vary considerably. Which groups in society do you feel will be most and least impacted?

Ben Zaranko: The Government's support package is broadly progressive. A clear focus has been put on targeting support for lower-income households. Given the broad and sweeping energy price guarantee, this winter, households will be insulated from the worst of the shock. The big question is about what happens after April with the design of the new scheme.

The two groups in particular that we might worry about are those that have high energy needs, such as someone who has a large family in a draughty house in a cold part of the country. We might also worry that, if the Government provides support just to people who are on means-tested benefits, what happens if someone is just on the wrong side of a sharp cut-off, or if they have not applied for benefits for which they are eligible? Some people who have high needs might not qualify for very much support at all, and those are the groups that we might be concerned about.

10:30

The more general point is that we know that inflation is higher for poorer households. They have to spend a much bigger fraction of their budgets on things such as food and gas, where inflation is at its highest. Even though benefits will be uprated in line with September's consumer price index in April, that will probably not keep pace with the inflation rates being faced by poorer households, which will exceed 10 per cent or so on average across the economy. We should be concerned about those groups in the coming years.

As you say, a 7 per cent fall in average living standards is horrific and it is going to hurt right the way across income distribution. That is why it is important that the Government spends time and effort on making sure that support systems are well designed and well executed.

The Convener: The prediction is that there will be a 1 per cent increase in real incomes by 2027-28. How can you possibly predict that level of growth at this point, given all the potential shocks that we might see? If someone had predicted that five years ago, everyone would have been astonished; five years ago, everyone expected that a five-year prediction would be much more positive. How big a pinch of salt do we need to take with the forecasts?

Ben Zaranko: The forecasts are subject to enormous uncertainty; that cannot be emphasised enough. Public finance forecasts and economic forecasts are uncertain at the best of times—they are very much an art, not a science—and nobody knows how the next few months will pan out, never mind the next few years.

Of course, it is possible that gas prices will fall back and that there will be some upside benefits to the public finances, for example. It is possible that interest rates will not increase by anywhere near as much as the market assumes, and they underpin OBR forecasts. That might mean that borrowing would turn out to be £10 billion to £15 billion lower, and that money could be reallocated to other priorities in public services or there could be tax cuts. There are potential upside benefits and there are risks; as you said, there are many potential shocks on the horizon and things could always turn out worse. If we have learned nothing else, we should have learned that from the past 12 months.

The key determinant is out of our hands: this is really about what happens to global energy prices, and when. Energy prices will be the key determinant of what happens to growth and household incomes. We can plan on the basis of the central forecast, but we have to recognise that there is uncertainty around it.

David Phillips: I would echo what Ben said, and I have two further points to make. First, as he said, the OBR has made what it thinks is a central forecast. The forecast is in the middle of the pack; it is not one of the more optimistic ones and it is not one of the more pessimistic ones. The Bank of England is much more pessimistic than the OBR, and there are two main reasons why, which are not to do with oil and gas and things like that because the OBR and the Bank of England tend to use similar information on those.

The main factor is an assumption about how consumers will respond to the recession. The OBR assumes that, in the current recession, oil and gas costs are things that people cannot cut back on so much, which is unlike the situation in most recessions, when people cut back spending and engage in what is called precautionary saving, More important is that many higher-income households will still have some pandemic savings that they can draw down. The OBR therefore assumes that consumer spending will hold up better than it usually does in a recession: the Bank of England does not think that that will be the case.

Secondly, the OBR is assuming that although productivity growth will not return to its pre-2008 level, it will start to pick up a little bit. The Bank of England’s projections assume that that will not be the case. The Bank of England shows what might happen if people are scared and do cut back on their spending, and if productivity does not return. Its growth forecast would mean a much weaker outlook for public finances and much bigger cuts.

However, as Ben Zaranko said, things might surprise us on the upside, whether that be through oil and gas prices or other factors such as productivity growth resuming at a faster rate.

My final point is this. Previously Rishi Sunak had planned to meet the fiscal rules, which were stringent, by providing more headroom, so that if there had been a bit of a surprise on the downside that was not too big, he would not have to revisit his plans. At the moment, Jeremy Hunt is within a hair’s breadth of meeting his rules, so if things turn out to be even slightly worse, that will mean either tearing up the rules or having more tax rises or spending cuts.

The Convener: We are basically walking a tightrope.

How much was the UK spend on interest on its debt in the most recent month for which you have figures?

David Phillips: I do not have those figures to hand; I do not know whether Ben does. In the medium term, the figure is forecast to be about £100 billion a year, which would be about £8 billion a month. I am not sure what the amount was in the most recent month.

Ben Zaranko: The OBR forecast is £120 billion for this year. The amount varies month to month, depending on the profile, but it is about £10 billion per month.

The Convener: Paul Johnson, who is the director of the Institute for Fiscal Studies, said:

> “what we are really doing is reaping the costs of a long-term failure to grow the economy, the effects of population ageing, and high levels of past borrowing”.

He concluded by saying:

> “we are in for a long, hard, unpleasant journey; a journey that has been made more arduous than it might have been by a series of economic own goals”.

What could the UK Government do differently and what should the Scottish Government do differently, in the view of the IFS?

Ben Zaranko: The biggest own goal this year was clearly the self-imposed fiscal crisis in the autumn. It is difficult to know what lingering impacts it will have, but in a bid to repair our reputation we have had to put in place more tax rises and spending cuts than we otherwise would. The clear lesson from that is that the messages that Governments and chancellors send to the markets and to corporate investors matter: announcing a large package of unfunded tax cuts, then going out and briefing the papers that there is more to come and hinting about restricting the independence of the Bank of England has consequences. We are adapting to a new world in which interest rates are starting to rise again and money is no longer as cheap as it was. The one clear lesson is that policy stability, fiscal credibility and commitment to clear policies and principles are important.

As Paul Johnson, our director, said, this is partly the consequence of more than a decade—15 years—of abysmal growth and an abysmal record on productivity. We still do not understand well enough what has been driving that. It is very easy to say that the Government should have done this or that, but it is hard to say what, with certainty. Hindsight shows us that cuts to things such as capital investment after 2010 were very sharp and deep, which probably contributed to a weakening longer-term outlook for the economy and public services, if we consider investment in hospitals, schools and the public sector estate.

The flip-flopping and constant changing of policy and the lack of an overall strategy on things like taxes does not help. There has also been a bit of neglect of further education, adult education and skills.

All sorts of things are easy to see with hindsight, but the big one is policy stability. That there should be a recommitment to a more sensible fiscal policy has been a clear lesson of the past few months. That is important, whether it is done by the UK Government or the Scottish Government.

The Convener: Of course, the Scottish Government does not have the same levers, which is why I asked what specifically the Scottish Government could do.

Perhaps David Phillips could say what the Scottish Government could do, given the situation that we are in.

David Phillips: You are right that, as the constitutional settlement stands, the Scottish Government does not have the same levers. In effect, therefore, it cannot do the same with borrowing and it certainly cannot make unfunded tax cuts as the UK Government can.

Some lessons can be learned from the current constitutional settlement; one of those is around strategy and prioritisation. The Scottish Government has a really ambitious set of welfare reforms coming down the track. At the same time, it is facing pressures on the national health service and many other public services. Squaring those two circles in a spending review proved to be incredibly difficult in the Scottish context.

One of the lessons is that when one has to live in a more constrained fiscal environment, one must think about what one's priorities are. Whether we see it in the forthcoming Scottish Government budget or in a future reassessment in a spending review, I hope that we see a grip being taken of the fact that it is not possible to deliver all that you want to deliver, given the fiscal environment, so there must be a strategy and certain elements of the policy package must be reprioritised. For example, what does the anti-child-poverty element mean for existing areas—for example, higher education, for which provision is greater in Scotland than it is in the rest of the UK? Alternatively, should you look to Scottish taxes in order to change the funding envelope?

There will also be implications if changes are made to the current constitutional settlement. The Scottish Government has made all the right noises about how it would approach public finances with fiscal rules, credibility and independent forecasters, and would not trash institutions as the UK Government did, to some extent. However, there is a bit of a disconnect between those right noises and some policy suggestions, which might not be consistent with the ideal of fiscal sustainability.

I have noticed that the Scottish Government is a broad coalition, so it needs a lot of different policies to satisfy that, which can sometimes mean a lack of focus on priorities. In a tight fiscal environment, whether as part of the UK or as an independent country, you need strong prioritisation to make sure that you are delivering your key aims within sustainable public finances.

The Convener: I have one more question, which is about the block grant adjustment OBR tax forecasts. We have already heard that we do not expect much, if any, growth in the next few years, and we have heard about how living standards are going to fall. The OBR has predicted that Scotland's income tax take, for example, will grow from just under £14.7 billion to just over £18.1 billion by 2027-28. That is a huge increase of almost £3.4 billion. Do you see that coming through fiscal drag or other measures?

David Phillips: Two forecasts on income tax are relevant to the Scottish budget. The first is the OBR forecast for revenues in the rest of the UK, and the other is the Scottish Fiscal Commission forecast for Scottish revenues. Those will be increased over the next few years because of fiscal drag, as the convener said. The current context is that real earnings are falling but nominal earnings are growing at a reasonably strong rate. The combination of freezes in the personal allowance and the higher-rate threshold, and the subsequent reduction in the top-rate threshold to just over £125,000 in the rest of the UK leads to quite substantial growth in revenues.

10:45

Compared to the last set of forecasts, the big change is that the UK Government's plan to cut the basic rate of tax to 19 per cent in 2024-25—Liz Truss had planned to bring that forward—has been abolished completely. Obviously, if you are not cutting tax rates in the rest of the UK, tax revenues will be higher than was previously forecast. At least in the short term, that will offset part and perhaps even all—I do not have the figures in front of me—of the impact on revenues of the weaker economic outlook.

At the point of the Scottish Government's spending review, it had not planned to cut its basic rate to 19p in the pound. Therefore, part of the funding that would be available from 2024-25 onwards was because, at that point, it was assumed that the UK Government would cut income tax but the Scottish Government would not. That would have meant that the block grant adjustment would not grow as quickly as Scottish revenues. That is no longer the case, which means that the SFC would not project a deterioration in Scottish underlying revenues relative to the rest of the UK. That policy effect will mean that around £400 million will need to be found in subsequent years from the Scottish Government's budget—because that funding will no longer come in a smaller block grant adjustment.

The Convener: I will open the session to colleagues. The first question is from the deputy convener, Daniel Johnson.

Daniel Johnson (Edinburgh Southern) (Lab): Thank you. I want to follow up on the point about tax revenue and the block grant adjustment. It has been a recurring theme at the committee, which has been looking at why we consistently have negative block grant adjustments. That is largely about the fiscal framework and our per capita income tax receipt growth.

Given that the OBR is projecting further negative block grant adjustments, is there any further insight to be drawn out on why our income tax receipt growth is slower in Scotland? Is there more detail on that, given that it is critical to our understanding of public finances in Scotland?

David Phillips: I will address that question. The SFC has looked into that, as has the Scottish Government, to some extent, in its previous reports. Historically, one of the factors underlying growth in the Scottish tax base being slower than growth in the RUK tax base—hence Scottish revenues not keeping up with the BGA—has been that a lot of the growth in the UK tax base has come from higher earners, especially people who are based in the south-east of England and London.

The Scottish Government did some analysis that stripped out London and the south-east, which showed that Scottish trends then look much more similar to those in the rest of England—the midlands and the north—and Northern Ireland. Another factor, historically, seems to have been underperformance of tax revenues in the north-east of Scotland, around Aberdeenshire, related to the oil industry. Again, stripping that out seems to reduce the difference.

That was what was going on historically. However, looking ahead, I am not sure whether that would be such a big part of the explanation. Freezes in thresholds and so on tend to raise more, relatively speaking, from the lower part of the income distribution, which there is more of in Scotland. A freeze in the threshold matters more relative to the amount of tax that you pay the lower down the income distribution you are. Therefore, looking ahead, what is happening at the top part of the income distribution might not be quite as important as it has been historically.

The SFC suggested that there are two factors at play. It is less optimistic about what is going to happen to Scottish employment rates than it is about rates in the rest of the UK, and it links part of that to the ageing population. However, it is not all to do with ageing; some of it is to do with lower employment rates among younger adults. I have not looked at the figures more recently—since the last SFC report—to see whether that has been borne out or whether that was simply a difference in judgment between the SFC and the OBR.

Daniel Johnson: It is important to keep a bit of a watching brief on that issue.

I have a couple of questions about inflation measures and, potentially, economic structure. We are seeing very sharp inflation, but it is being driven by a combination of very specific things. For example, there is the increase in wholesale gas prices, which is being experienced across the world. Likewise, the war in Ukraine is a specific event, but given the critical importance of Ukraine for basic agricultural goods such as sunflower oil, it is having very particular impacts. Although we are seeing very sharp inflation, it is lopsided. For example, skimmed milk is one of the goods that has experienced the highest inflation, at around 30 per cent.

Not all people will buy the same basket of goods, and Governments do not buy the same basket of goods that people buy. Do we therefore need better measures in order to get a true grasp of how much Governments' and people's spending power has been reduced so that we can understand how much money we have to spend?

David Phillips: I will come in first on the point about inflation measures. I am sure that Ben Zaranko will add a lot; the gross domestic product deflator is one of his pet interests.

On inflation measures and the impact on households, although increases in price were, at least initially, very highly concentrated, a worrying sign is that inflation has been leaking out across broader categories of goods and is not as concentrated in food and energy as it once was; we are seeing increases across a wider range of goods and services. Core inflation—stripping food and energy prices out—is starting to rise, which can lead to worries about whether higher inflation will be more difficult to address than the OBR and the Bank of England hope, once it starts affecting expectations beyond energy and food.

The second point on broader inflation is that the Office for National Statistics has started to produce a wider basket of inflation measures that look at whether price increases are particularly high for basic products—such as for Tesco value as opposed to Tesco finest products. There are more measures there.

The cost of inflation to Government is traditionally measured using the GDP deflator, which has been moving in some rather odd ways over the past couple of years. When considering the real-terms change in Government spending power, and the inputs that Government can purchase from those spendings, it is probably the case that we potentially need a new inflation measure. I will pass over to Ben Zaranko, who can say a lot more about that issue.

Ben Zaranko: On the first part of Daniel Johnson's question, as David Phillips said, core inflation is now running well above target. If we look at what is happening to average earnings growth, which is at 6 per cent across the UK as a whole, and at average cash earnings growth, it is hard to reconcile it with inflation at a 2 per cent target. Inflation is right through the economy and is probably running at more than 2 per cent across all sorts of goods and services. That is probably what the Bank of England is most focused on when it is thinking about its decisions on interest rates.

Daniel Johnson is right that we do not have a great measure of what is happening to the cost of running public services. For example, we have traditionally relied on the GDP deflator, which is a measure of domestic economy-wide inflation. That matters at the moment, because a domestic measure of inflation will not include rising prices of imports. We import lots of food and lots of gas, but that does not enter the GDP deflator—which has been running much lower than CPI, which is a measure of the rate of inflation facing households.

The tricky thing is that CPI is also not a good measure of the inflation rate facing, for example, hospitals and schools. Gas, food and fuel represent a much bigger fraction of a household's budget than of the budget of a hospital, a general practitioner practice or a nursery.

Staffing costs clearly enter much more prominently into the running costs of public services, so, to some extent, the figure is determined by Government pay decisions.

It would be valuable for the ONS to try to construct a public sector inflation measure. There used to be a health sector-specific one, which was discontinued around 2015. The evidence base is lacking a little bit. When you make assessments of what is happening to the real-terms value of grant funding or budgets, it matters which inflation measure you use. What we might call the true rate of inflation that public services face probably lies somewhere between the CPI and the GDP deflator, but precisely where it lies is a matter of judgment. That evidence is lacking and some of the Government's statistical agencies could usefully do work on it.

Daniel Johnson: I will conflate two slightly different issues, but they come down to the same point, which is how we gain a better understanding of inflation and our lack of growth.

There are some things for which we do not have accurate insight or an accurate measure. First, we still have relatively higher energy prices compared with Europe, especially for electricity generation. That does not entirely make sense to me, especially if we compare the situation directly with that in other countries with similar energy production composition, such as the Netherlands. Electricity prices in the Netherlands are about 20 per cent lower than they are in the UK.

Given how expensive the energy intervention is, do we need to compare more carefully what we have done in the UK on the price cap with what other countries have done? I can understand why different countries might be different if the composition of their energy production or consumption is different, but the Netherlands is comparable with the UK in its economic mix and production. Do we need to examine that more carefully and try to measure it, given that the point is becoming so critical?

Likewise, you said that we do not quite know why we have had a lack of growth in the past 10 years but, broadly, we know that the fundamental problem that we have in the UK is a lack of Government and private sector investment. Do we need to measure that more carefully and precisely? In your previous answer, you mentioned the cuts in capital investments. Do we need to measure our energy market and investment more closely? Would it help our fiscal position if we understood them better?

Ben Zaranko: That is right. There is some truth to the famous management consultant maxim that what you can measure is what you can manage.

Neither David Phillips nor I are energy market experts, but, given the huge sums that are being spent, there is clearly a need for even small changes that might help to increase energy efficiency or improve the functioning of the electricity market. Such measures have the potential to save large sums. I gather that the Government did work on market reform of the electricity sector but, as I said, I am not an expert and I do not have much to offer on that.

We have the data to measure and show that UK business investment has lagged behind investment in other developed countries for some time. Government investment has also lagged behind other countries for some time. We can measure and observe that. However, getting granular data can sometimes be difficult. It is difficult to identify the effects of interventions that are slow moving, the effects of which do not come for a long time, when there are lots of other things going on in the background, but there is a consensus that high levels of investment might have been good for growth, particularly in certain sectors.

Better measurement is part of the answer, but it also has to be a question of priorities and policy stability. When it comes to corporate taxation and trying to encourage business investment, there is a lack of a clear, overall strategy. Such a strategy would be just as beneficial as better management and measurement.

The Convener: Abolishing the transmission charges imposed on Scotland by the previous Labour Government would also help.

David Phillips: On the point about energy, as Ben Zaranko said, the UK Government is planning reforms to the energy market. One of those reforms would fillet the market so that, rather than there being one marginal price that determines the price of all electricity, which is usually the most expensive one at any one point—currently, it is the gas price—there would be, for example, long-term contracts for renewables at a lower price and there would still be a marginal price to ensure that you do not run out of supply.

11:00

Again, that could be the gas price as it is now, but there would be separate prices in the market. That could end up reducing the overall average price and we would not then have a situation where, when the gas price is high, there are windfall profits for renewables producers.

The reason that I am speaking about that in a bit of detail is that it will have implications for public sector and other organisations that currently say that they want to use renewable energy. In a world where we have two separate prices, consumers will not be able to choose to use renewable energy because otherwise they would all choose to use the lower-priced one. In future, if we have this split market, there will be no such thing as having renewable energy-only contracts; there will have to be some bundle of energy that everyone buys from. So, while you are splitting up the energy market to enable there to be different prices, we would be bundling it together when it comes to consumers and businesses buying that energy, so that they could not undermine that splitting of the price by all piling into the lower-cost one.

Energy market reform is potentially useful, but it does mean changes to the position that people have got used to—particularly those who think, "I am being green, because I am buying green energy." If we try to change the prices we will not be able to do that in the future.

Daniel Johnson: Finally, I say to Ben Zaranko that "You cannot manage what you do not measure" is one of my favourite sayings. I thank him for using it.

Liz Smith (Mid Scotland and Fife) (Con): I want to ask a technical question on the back of commentary by some economists that, following the end of lockdown and the severe restrictions that we all faced when we were unable to do some things, service industries are beginning to be rebooted. Can you put your finger on any evidence that that is happening a bit more successfully than in other areas of the economy, because we are now out and about and taking advantage of services that we could not use previously? Have you any data to suggest that that commentary is accurate, or is it too early to tell?

Ben Zaranko: There is a really interesting story here, contrasting the position in the UK and Europe with that in the US. Clearly, during the UK lockdown there was a swing away from services, including restaurants and so on, towards goods. It is interesting that, in the UK and Europe, the position on both goods and services has normalised back towards the pre-pandemic trajectory. The mix there has not shifted permanently.

In the US, that shift has lasted, and the lasting increased demand for goods and lower demand for services there was part of what was driving inflation higher earlier there than was the case here. Reconfiguration has been more difficult in the States, where it has been exacerbated by global supply chain disruptions.

In the UK, the evidence is that the mix of goods and services is back to where it was. The more lasting impact has been on where people spend their money. There is great data on, for example, the use of credit card transactions, from which we can see that there has been less spending in city centres and more in commuter towns where people live and now spend more time if they are working remotely. That geographical shift is potentially a more lasting one than the change in the mix of goods and services.

David Phillips: I would add only one point. I notice that, today, the BBC has published its research on changes in high streets across the UK. It suggests that, within services, there has been a little bit of a shift—at least on high streets—in who is occupying properties. Perhaps somewhat surprisingly, for the first time in a long time, there has been an increase in the number of pubs, restaurants and cafes, beauty parlours and tattoo surgeries, while the numbers of shops, banks and other establishments have changed. Apart from in the pubs sector, where there is a little bit of a reversal, that means that there has been continuation of the trend that we saw before the pandemic where the move to online retail and banking means that shops and banks are still closing down, but high streets and commercial areas are reorienting towards experiences and personal services, such as restaurants, cafes and beauty parlours.

Liz Smith: I heard that interview, too, and I thought it was interesting. It also flagged up that there are regional differences in the ways that people are reacting to their local high streets, which is another potential worry.

Obviously, different factors affect inflation—there can be demand-pull or cost-push scenarios. Is it your understanding that the greater component of high inflation has been more on the cost-push side than the demand-pull side—whether that has been because of a lack of supplies from Ukraine or the huge hike in energy prices?

David Phillips: It is my understanding that the big driver of inflation has been the supply shock to both food and energy, and previously, to some extent, it was caused by supply chain issues. However, the labour market has also been really quite tight, and we have seen wage pressures creep up. Wage increases have not happened as fast as price increases—they have not kept pace with that—but they have risen substantially, and in certain sub-sectors there have been very substantial increases in wages. My view is that the inflation shock has largely been driven from the supply side, but demand has also been relatively robust, and that might have meant that the issue has become more entrenched than it otherwise would have been.

Liz Smith: I asked that question because we have suffered from fiscal policy and monetary policy pulling in opposite directions. The UK has been trying desperately—perhaps not very successfully, at one stage—to get the right balance on fiscal policy, whereas the Bank of England’s remit is to control inflation, and therefore monetary policy has pulled in the opposite direction. That difficulty means that it really matters what kind of inflation it is, which allows us to determine what policies are put into practice, which is why I asked that question.

David Phillips: That was a really interesting question; let me think about it for one second. If Ben Zaranko has any thoughts on it, he can come in before I do.

Ben Zaranko: Sure. I think that, clearly, the disconnect between fiscal and monetary policy was greatest in September, around the time of the so-called mini-budget.

It is difficult because for most of the past decade quite a strong argument could have been made that a slightly looser fiscal policy and a slightly tighter monetary policy might have been a better policy mix. Rather than conducting such a sharp breed of austerity, the Government could have had slightly higher interest rates. However, that argument has almost flipped this year as interest rates have started to rise and inflation has gone up, globally.

Clearly, this inflation episode has its origins in global energy markets and a global supply-side cost-push shock, but the danger that the Bank of England worries about is that that is embedded in wage expectations, particularly in an economy that does not have a great amount of spare capacity or slack. That is worsened by the fact that the labour force is shrinking because of rising rates of inactivity, and so on, but it is not as if we have got very high levels of unemployment. There is a concern that what started as a cost-push episode could become embedded in expectations, and that it could become much harder to try and squeeze out. However, you are right that the policy mix matters a lot, and there is a delicate balance to be struck.

One of the motivations behind the Sunak and Hunt policy response, when they came into Government was, “The more tightening we do, the fewer interest rises the Bank of England will have to make,” but the Bank of England knows that and takes account of it in its policy-making processes. It gets complicated, and without explicit co-ordination there is a risk of disconnect between the two. You framed your question in exactly the right way.

John Mason (Glasgow Shettleston) (SNP): I am interested in the level of interest rates. At 4 per cent, they are felt to be high at the moment, but they are considerably lower than inflation. If that was to continue in the long term, would everybody not just borrow and make a profit? Are we in an unusual situation at the moment, or could it continue to be the case in the long term that inflation is higher than interest rates?

Ben Zaranko: You are right. There is a concept in economics called the real interest rate, which is basically the normal interest rate minus inflation. At the moment, inflation is higher than the normal interest rate, so we have negative real interest rates. In normal times, we would expect that to be a stimulus to economic activity.

The Bank of England expects inflation to fall back over the next few years, as gas prices start to fall in the way that we hope and its monetary policy tightening feeds through. The market expects interest rates to be a bit higher in a few years’ time, but the Bank of England has signalled that we might expect to have interest rates of about 3 per cent. As inflation falls back, under the OBR forecast, the CPI is set to turn negative. Therefore, in a few years’ time, we will no longer have negative real interest rates.

In the period of low interest rates that we have just lived through, the Bank of England base rate has consistently been at a fraction of a per cent, with inflation at a much higher level. We have had negative real interest rates for the past 10 years without having a borrowing-fuelled boom. That was not enough to stimulate a period of massive economic expansion. Therefore, it is clear that the real interest rate is not the only thing that matters. I hope that that addresses your question.

John Mason: I am still slightly puzzled, but I accept that there is not a clear-cut answer.

Liz Smith asked about the prices of gas and food and what was driving inflation. Can we compare the situation here with that in other countries? Are other countries—western countries, especially—in much the same position? Are there differences in the inflation level in neighbouring or similar countries, or in the reasons for inflation?

David Phillips: I will come in on that one first, and I might go back to some of your previous questions.

There is a range of inflation rates across developed countries. The UK's rate is reasonably high by the standards of north-western Europe, although Germany's has been creeping up, too. It is somewhat lower than the rates of most countries in central and eastern Europe. Inflation in Europe has been driven to a large extent by energy prices. Differences have been to do with differences in countries' energy mix and differences in their policy response to the energy crisis.

In the US, energy has not been such a big issue in the inflation increase there. Inflation in the US peaked earlier, and it now seems to be coming down. Supply constraints have been a more important issue in the US. As Ben Zaranko said, there is excess demand for goods relative to services. That has had an effect on oil and petrol prices, and also on the price of second-hand cars. That was a bit of a factor in the UK at one stage, but I think that that has moved out of the system.

The factors in the UK are similar to those in the rest of Europe, but the impacts vary, based on the policy response, the energy mix and other factors, such as currency movements. Many parts of eastern Europe do not use the euro and a depreciation of their currency has also pushed up inflation. That was probably pushing up inflation in the UK as well, although the fact that the pound has regained a lot of the ground that it lost previously might start to pull inflation down a bit.

To address the previous question about the nature of the current shock and the policy response to it, the only point that I will add to what Ben Zaranko has already said is that, if a supply shock were to hit at a time when we had significant spare capacity in the economy, we might not need such a large monetary policy or fiscal policy response because, with a lot of slack, we would expect that higher inflation would be less likely to translate into higher wage growth and, therefore, a wage price spiral. However, a tight labour market combined with a supply shock means that the policy response needs to be a bit more aggressive in order to bring inflation down.

11:15

John Mason: My understanding is that the OBR's forecasts assume quite a big increase in fuel duty next April. The suggestion was that, if that does not go ahead, there could be a £6 billion hole in the UK Government's finances. Can you say anything about that?

Ben Zaranko: The OBR is required by law to take Government policy as stated. It is Government policy for fuel duty to go up next year. Clearly, the sensible bet would be that it will not, given the experience of the past decade and the state that UK household finances are in. We should expect fuel duty not to be increased, which would create a hole in the UK Government's plans. It probably has about £10 billion of headroom against its fiscal targets. By itself, not increasing fuel duty would not be enough to put the Government on track to miss those targets; however, it would clearly matter.

That is one of many of what we would call policy risks that the OBR is not allowed, or able, to take into account. That includes things such as tax rises or spending cuts that have been promised that do not go ahead. Such things are built into the public finance projections that are produced by the OBR. However, if we consider how tight spending plans look after the next general election and what that might imply for areas such as local government in England, it is very difficult to see how those policies could be implemented in their current state, and so plans might change. Fuel duty is very much in that camp. It seems almost certain that the increase will not go ahead.

John Mason: That is very helpful. Thank you.

Ross Greer (West Scotland) (Green): I hope that you do not mind me jumping between a few different areas. First, I will follow John Mason's line of questioning around inflation. I am interested in your thoughts on debt interest. It feels as though the era of cheap money is over globally, at least for now. However, the UK went through a particular episode with debt interest rates on the back of the mini budget. What is your expectation of the rates over the next couple of years?

Ben Zaranko: The Bank of England did some internal modelling, and it thinks that there is a UK-specific element to the problem. Interest rates are rising globally, but according to its model, interest rates have risen even more in the UK because of a UK component of how the market is treating UK Government debt.

The OBR considers the market's expectations—so, what the market as a whole, or on average, thinks is going to happen to the Bank of England's base rate. The Bank of England has been sending quite a strong signal and saying to the market, "Rates are not going to rise as much as you think they are." It has produced different scenarios or forecasts for the economy: one that is predicated on market expectations for interest rates and another that is predicated on interest rates going to 3 per cent and then staying there. The bank is quite clearly signalling that it thinks that interest rates will not have to go as high as markets think that they will, which matters a lot for the UK's public finances. The OBR factors in the market's expectations, but if interest rates do not go up by that much, public finances will be in a better position.

One reason why that matters a lot in the UK is the interaction between quantitative easing and the Government's debt interest bill. To simplify what is quite a complicated story, increases in the Bank of England's base rate feed through very quickly into the UK's higher debt interest bill, because of the fact that the bank is holding a large amount of gilt on its balance sheet. What happens to those interest rates matters an enormous amount for how much the UK has to spend on debt interest and, therefore, how much is available for other things. That is a really important question, and it will matter significantly to how fiscally tight things feel over the next few years. Whether the market turns out to be right—or not—will be enormously important.

Ross Greer: I will jump to a completely different area. I take on board what you said earlier about neither of you being an energy policy expert, but are either of you aware of any work being done on the impact of windfall tax loopholes? I think that Shell was the company that most recently reported that it has managed to avoid paying any windfall tax. That was as a result of its North Sea exploration activities giving it sufficient relief from the tax. Are you aware of any work being done to identify whether that loophole creates an incentive for companies to pursue exploration that they had not planned before the introduction of the windfall tax?

David Phillips: I will come in on that, but I might circle back to your previous question, too, if I may.

I am not aware of any specific work on that issue. I am aware that Shell has said that it does not expect to pay the windfall tax this year but that it does expect to pay it in subsequent years, and that BP has said that it expects to pay it this year and in future years. You are right that that relates to investment.

A feature of the scheme was that the Government wanted not only to offset the effect of the higher tax on investment but to potentially encourage investment overall. That was perhaps not fully stated, but the scheme was seen as a way to increase the supply of domestically provided oil and gas in order to make us less dependent on international markets. We can debate whether that policy is good or bad, with the balance between having energy security in relation to prices and the need to transition away from oil and gas to get to net zero. I would not want to say that nobody is looking at the issue that you raised, but I am not aware of anyone doing so.

On your previous question, there is an interesting interaction between the OBR and the Bank of England. The OBR's forecasts build in market expectations about what will happen to interest rates. The Bank of England has signalled that it thinks that those expectations might be too high, but that is based on the bank having quite a pessimistic outlook for the economy. If the economy turns out to be stronger than the Bank of England expects, it may be that the market expectations for interest rates are not too high, so the bank would have to set interest rates higher than it thinks it would have to otherwise. Therefore, interest rates could end up being closer to the market expectations.

I am not sure that that was very coherent, but the point that I am trying to make is that forecasts for the fiscal side of the equation are being made by one forecaster and forecasts for the monetary side of the equation are being made by a different forecaster. When those forecasters have different judgments about the state of the economy, that might lead to policy not being optimally aligned between the two sides of the equation. If the Bank of England assumes that the economy will be weaker than it turns out to be, and if the OBR assumes that the economy will be stronger than it turns out to be, that could lead to mismatches in policy. We also see that in the Scottish context, where the SFC and the OBR make forecasts on different sides of the revenue equation.

There is an interesting issue relating to how forecasters communicate with one another. On the one hand, we do not want them to share too much, because we do not want groupthink; we want to have different opinions and insights about the economy. On the other hand, if forecasts are made based on fundamentally different judgments, that can sometimes lead to policies not aligning or to forecasts not aligning, which can have knock-on effects on fiscal policy.

Ross Greer: Those were really interesting points, so I appreciate your circling back to my previous question.

My final question is on a different area. When lowering the threshold for the top rate of income tax has been considered in the past in Scotland—

recent tax papers by the Scottish Trades Union Congress and the Institute for Public Policy Research have included proposals in that area—the counterargument has been that that would result in significant behaviour change and would not raise additional revenue.

Part of the argument is that a Scotland-specific reduction in the threshold could result in people on higher incomes simply moving elsewhere in the UK to avoid paying the additional rate. If the Scottish Government follows the UK Government's lead in reducing the threshold to £125,000, that behaviour change element will be eliminated, although there will still be the prospect of people converting their income into other forms to avoid paying income tax.

Do you expect tax avoidance-related behaviour to change in that regard? I have to say that I have never found the argument to be massively credible, but I am interested in your thoughts on it.

David Phillips: The Scottish Government has looked at those issues previously and has said that it needs to consider two factors. One is migration to the rest of the UK. The second is that, because Scottish tax rate changes apply only to non-savings and non-dividends income, and therefore a change in the Scottish rate opens up a bigger gap between the Scottish earned income tax rate and the dividends income tax rate, there might be additional avoidance. If the threshold is reduced across the UK, migration within the UK is not an issue, as you said, although there could still be international migration.

The issue of people shifting to dividends income depends on whether the Government also increases the dividends rate over that income range of £125,000 to £150,000. I think that it will: it has reduced the income tax additional rate threshold, and there is a linked additional rate threshold for dividends income, which I think will come down, too. Therefore, I do not think that a gap will open up.

Overall, I think that, although there will still be a behavioural response if Scotland follows suit now, it will be substantially reduced, because the migration angle is closed and, although there is still a gap between dividends income tax and earned income tax, I do not think that that gap will get any larger than it is now, because the dividends income tax will come alongside the UK income tax rate for that income range.

On the scale of the behavioural response, the forecast by HM Revenue and Customs, as vetted by the OBR, is that the change will raise about £800 million across England, Wales and Northern Ireland. That would build in a substantial amount of behavioural response—I have not looked at what elasticity is assumed or at the pre-behavioural-response revenues, but it would not surprise me if they were two to three times larger. I would expect a similar measure in Scotland, given the taxable capacity of Scotland, to raise around—this is off the top of my head—£30 million to £40 million.

An interesting thing is that, overall, Scotland could lose from the policy, because the block grant adjustment will go up to reflect the percentage change in the rest of the UK. Because there are more higher-income earners in England, particularly in London and the south-east, there will be a bigger percentage change in revenue in England and Northern Ireland than there will be in Scotland from the same tax change. Therefore, if Scotland follows suit with the tax change, it might lose a few million pounds, because the block grant adjustment will go up by more than the tax revenues for Scotland go up.

Ross Greer: You have hit on a key area that really needs to be considered in the review of the fiscal framework, which is the perverse incentives that it creates.

Douglas Lumsden (North East Scotland) (Con): House prices are starting to fall. What impact will that have on the UK economy and the Scottish budget? Will there just be a reduction in land and buildings transaction tax revenue, or will there be a block grant adjustment around that? Where do you see things going?

David Phillips: I will talk about the revenue side, and Ben Zaranko might add something about the broader economy.

The impact on the Scottish budget will depend on the relative impacts on revenues. The fall in house prices, and in particular the fall in the volume of transactions, will reduce revenues from LBTT and, in the rest of the UK, from stamp duty land tax. There will be lower revenues, but also a lower block grant adjustment. The question is which of those outweighs the other, hence the net impact on the Scottish budget is uncertain. It will depend on a couple of factors.

11:30

The first is which part of the market is most affected by the slowdown in transactions. If it is the top of the market, on the one hand, that is a bigger share of the market in England and Northern Ireland, mainly because of London. On the other hand, the Scottish Government has a much more progressive structure for its tax system so, conditional on the distribution of property values, more comes from the top part in Scotland because of the tax rates. More of the bottom of the market is in Scotland, but Scotland has lower rates at the very bottom.

A picture of the net impact is, therefore, really quite complicated to predict. It will depend very much on which parts of the market are hit most and whether the distribution of Scottish prices being lower outweighs the tax rate being more progressive or vice versa.

I do not want to try to make an accurate prediction; I will simply say that there will be a change in the block grant adjustment, and whether it partially offsets, or more than offsets, the fall in revenues in Scotland, is difficult to say at this stage without further in-depth analysis.

On the second point around powers that affect the wider economy, there will be two such effects. First, there might be a wealth effect: lower property prices may mean that people feel less wealthy, which could translate into lower consumer spending. There is evidence that the wealth effect of property prices matters for consumer spending, at least to some extent. Secondly, property transactions are associated with activity around improvements, new white goods and furnishings and so on, so there could be an impact on the retail and building sectors.

Douglas Lumsden: My second question is about the energy price cap, which is quite an expensive scheme for the Government to run. Are there equivalent schemes in other parts of the world?

David Phillips: There are equivalent schemes in other countries. For example, France was, for a long time—although I am not sure what the situation is now—capping its increases in electricity prices at 4 per cent. That is one of the reasons why French inflation remains so low. To an extent, France could do that because a lot of its energy is nuclear and state owned so, in effect, rather than having a windfall tax, the windfall was being captured by a state-owned enterprise anyway.

Other countries have adopted different schemes. Austria has quite a generous scheme, and Germany has a scheme that significantly reduces energy prices but, unlike a cap, does not completely cap them at the margin. It therefore still allows for some of the impact of the higher marginal price to fall through to consumers and businesses, so they still have a strong incentive to cut back on their energy use.

That subject is of interest, and colleagues of mine have produced figures on how much energy bills are increasing for different types of households over the next six months. I can either send those figures to the committee after the meeting or state some of them for the record now, if that would be useful.

Douglas Lumsden: Yes, that would be helpful.

David Phillips: Should I forward them or state them now?

Douglas Lumsden: If you can provide them offline, that would be great.

The Convener: One of the interesting things about the autumn statement was that the UK Government decided to close the Office of Tax Simplification. What was the reason for that decision, and what will the impact be? It is not being reversed by the new Chancellor of the Exchequer.

David Phillips: I am aware of that, but I have not looked in detail at what the stated reason was. It is a disappointment that it is being abolished. Although the office did not have as substantial an effect on simplifying taxes, and particularly on seeing where the discrepancies between tax treatments of similar activities could be reduced, as we at the IFS might have hoped, it still played at least some role in ensuring that issues of simplicity and interactions were taken account of. It is disappointing that it was abolished and has not been resurrected.

Ben Zaranko may have more to add.

Ben Zaranko: I have nothing further to say.

The Convener: I would have thought that the idea of an office that tries to make tax simpler and more understandable would be a positive thing.

The OBR mentioned unemployment, which we have touched on only peripherally. The OBR expects UK unemployment to rise by between 3.6 and 4.9 per cent by 2024. That will be a significant proportion of the workforce, at in excess of 1.5 million people. What might the regional impacts of that be? How do you anticipate that impacting on Scotland?

Ben Zaranko: I have not looked at that in detail. My first instinct is that a lot will depend on industrial positions and on which sectors—for example energy-intensive sectors or manufacturing—are particularly hard hit in the next few years. The geographical footprint will be different, depending on where unemployment rises most.

There is an interaction between having a tight labour market and a potentially shrinking workforce. Rising unemployment will have an impact on wage demands and on the potential for industrial action. All of that interacts. I am afraid that I do not have any particularly well informed views on Scottish unemployment relative to the rest of the UK.

The Convener: Even in the broadest sense, if we have 1.6 million or 1.7 million people who are unemployed and about 5 million who are economically inactive, that will clearly have a major impact on growth, productivity and tax revenues.

Ben Zaranko: Absolutely. If more people are out of work or inactive, that is all part of weakening demand. What is more concerning is what that implies for the productive potential of the economy. If there are people who might previously have expected to carry on working for another 10 years, or if lots of young people are dropping out and claiming disability benefits, those people will not be contributing in the same way to UK production, which raises concerns. That is why health is a major input into our productivity and economic prospects. It is really concerning that there is a growing body of evidence to suggest that the health of the UK population and workforce has worsened, which will have an impact on growth rates and future tax revenues. That should be an area for policy focus.

The Convener: David, do you want to come in?

David Phillips: I have two brief points. The first is about Scotland. Generally, during an economic downturn, we would expect areas with a higher reliance on the public sector to see less of a fall in employment, because public sector employment is less cyclical than private sector employment. It is not clear whether that will be the case in the future.

Where there is a fixed or constrained budget and higher pressure on wages, one of the few ways to address that without increasing taxes or cutting social security spending is to cut the head count in the public sector. I am aware that, in its spending review, the Scottish Government was already pencilling in cuts to the public sector head count in order to make those figures match. If inflation and wage growth are higher than previously expected and budgets are not increased, that could put further downward pressure on the public sector head count, which already brought delivery challenges in the context of the demands being placed on public services.

That was the Scotland-specific point. The broader point comes back to what unemployment and economic inactivity mean for the economy. During the 2010s, the increase in economic activity was a notable bright spot in the economy. We saw quite a substantial increase in employment during the 2010s, which, to an extent, masked poor productivity. If there is a pause in that increase in activity or a reversal—a rise in inactivity—productivity growth will be even more important for economic growth.

The Convener: Earlier, you talked about the changing footprint of public services relative to the pre-pandemic position. What impact do you think that that will have on the Scottish budget?

I ask that, because I read at the weekend that, although the number of passengers on buses is still below the pre-pandemic level, it is approaching 90 per cent of what it was before; however, rail passenger numbers are barely at 50 per cent of the level that they were at before the pandemic. I believe that the Scottish Government spends just over £1.5 billion subsiding the railways in Scotland. Therefore, one would anticipate either a significant increase in public support for the railways or, indeed, a reduction in services, which will have knock-on effects, including on reliability, because of strikes, staff shortages or whatever, and on the drive to get people to switch from cars to public transport. What effect is the impact of the pandemic likely to have on public transport in the Scottish budget?

David Phillips: I will deal with the Scotland-specific points first. One of the savings that the Scottish Government made in this year's budget was a result of lower bus usage—there was less spending on concessionary fares. In the short term—with buses, at least—some money might be saved as a result of lower usage. Of course, if there is lower usage more generally, some services might become unviable and, in order to maintain them, there might need to be higher subsidies.

A far bigger issue is that of rail services. During the pandemic, there were very substantial increases in state support for rail services, and the UK Government has been trying to unwind that. The reduction in state support at a time when passenger numbers have not fully returned to what they were before is one of the reasons for the industrial relations issues in the rail industry. There is a potential shortfall of income that operators are trying to make up for, and one way in which they can do that is through rationalising expenses, including labour expenses.

How significant that will be for Scotland in the future will depend on the extent to which passenger numbers return to previous levels and whether the Scottish Government shifts the mix when it comes to the funding for Scottish rail. I think that Scottish rail has the highest ratio of subsidy to passenger fee income in the UK, largely because it serves a large network and a sparse population, and that might need to be looked at.

I do not know whether Ben has any comments to make on the broader UK-wide figures.

Ben Zaranko: A quick big-picture point that I would make—and which is true of the railways, the NHS and the education system—is that, early on, there was a hope that Covid represented a one-off, time-limited shock that we had to provide support for in order to get through and after which things would return to normal. However, it is becoming clearer, particularly in some settings, that the shock of Covid has been more persistent or permanent, and that is true in relation to passenger numbers and health service productivity. As a result, we might have to provide more funding persistently—indeed, indefinitely—just to get the same level of service, which might mean, say, providing more public subsidies for the buses or railways and having to spend more on the health service to get the same volume of care, because of the hit to productivity as a result of infection control measures. Covid's long-lasting impact will have an impact on public services, and it is a really difficult issue that all levels of Government will have to grapple with.

11:45

The Convener: A lot of the money that was underspent on the concessionary fares scheme for young people was switched to bus services in the summer to ensure that they did not fold. That was the case with some local services in my constituency.

Michelle Thomson (Falkirk East) (SNP): Going back to the convener's point about the Office of Tax Simplification, I note the big numbers that have been bandied about—the £6 billion black hole in the finances, the fuel duty escalator and £10 billion per month on debt interest. The National Crime Agency estimates that about £100 billion each year is lost to the UK as a result of money laundering while—although figures vary here—roughly £190 billion is lost every year, because of fraud.

The scale of those figures is staggering. Might the IFS consider looking more actively at that, given that we have almost a shadow economy running? The UK Government appears to have no appetite to tackle it; indeed, it is getting rid of the Office of Tax Simplification, even though it is the complexity in the tax system that provides the wriggle room for those startling losses to UK GDP. I am surprised to hear that neither of you has followed up on the plan to get rid of the Office of Tax Simplification.

David Phillips: On your last point, we have a tax sector at the IFS. Those colleagues might be a little bit more on top of the issues but, unfortunately, they are on leave at the moment.

As for the role that we can play, we do a lot of research on tax avoidance, tax evasion and the impact of audits on tax receipts, and we will continue to do that work. There is also a tax law review committee that is co-ordinated by the IFS but which involves tax lawyers and tax accountants as well as an economist or two. It considers particular areas of tax where the law could work better; some of that is about implementation, ease of use and whether the law is having the impact that it should be having, and some of it is about avoidance and evasion. Therefore, we are considering the matter.

The main organisation that considers the overall scope of error, avoidance, evasion or fraud, though, is HMRC. It publishes a tax gap analysis every year, which is a useful publication; in fact, one of my other areas of work is in developing countries, and we have been trying to get them to do more such work.

There is work to be done in the area. I agree that the removal of the Office of Tax Simplification was a step backwards, but the office was not the main actor in the area; its main role was simplifying tax instead of designing and enforcing rules on evasion and fraud.

Ben Zaranko: It is right to focus on the resources that are available to the enforcement agencies. Budgets for HMRC and the National Crime Agency, for example, have been squeezed over the past decade or more, and you will see something similar with the Environment Agency. You cannot slash the budget and expect the agency to be able to enforce just as well as it did previously. Therefore, there has to be a focus on those budgets.

If tackling fraud were simple and easy, I do not doubt that the Government would do it to raise more funding. The challenges are long term. The scrapping of the Office for Tax Simplification is unfortunate—its aims aligned well with ours—but looking at it through the lens of the battle against fraud and tax evasion, I do not think that it is necessary .

I should say one final thing. Some IFS research fellows and academics who are affiliated with the IFS have done lots of work on the tax activities of non-domiciled individuals to look at how we can raise more money from the very richest. We are doing lots of research in that area, but perhaps not directly on the issue of money that is lost through fraud.

Michelle Thomson: I am sorry if I sounded as though I was having a pop at you, David; I totally appreciate that your expertise cannot cover everything. Perhaps, though, we can fold the issue into future sessions, because the fact is that, although we are talking about what feel like quite big numbers, they pale into insignificance when we look at the whole gamut. You are correct in what you have said about cuts to HMRC, which suggests that the issue will get only worse, rather than better. Although you are right that this is a global issue, the UK is well up the league table for this; I think that it is the second most corrupt country in this regard after the US, although people might argue about that. That is important, because we tend to look at what we can see rather than guess at what we cannot see, which is growing at a rate of knots.

The Convener: I do not think that it helps to have tax havens in the British isles, if we include the Channel Islands and the Isle of Man.

We have talked about the GDP deflator, but what matters to people who put in pay claims is public perception. I would therefore suggest that this is all about headlines, which have a significant impact on the public sector, rather than the GDP deflator. The UK Government might say, "The Treasury costs are blah blah blah, so that is the GDP deflator," but that is not how the public see it—they just see what is on the news and in the papers.

Ben Zaranko: That is the challenge. Public sector workers clearly care about the rate of inflation that they face in the shops on the things that they purchase. That is best captured by something such as CPI, which is running in the region of 10 per cent, so a pay offer of 5 per cent will clearly represent a real-terms hit to their pay and living standards.

The challenge for public services generally is that all the budgets were set when inflation was not expected to be so high. If budgets have been predicated on pay awards of 2 or 3 per cent, an offer of even 5 per cent will feel really painful, and savings will need to be made somewhere else. However, 5 per cent still feels like a real-terms cut—in fact, it is a real-terms cut—for those workers.

Both the workers and the people who are trying to manage the budget for public services can feel legitimately aggrieved about being in this difficult situation. Public sector pay is a really tricky area of policy at the moment. I am not saying that nurses, teachers and train drivers should not be focused on CPI or the rate of inflation that they face—of course they should be—but we need to consider the issue in the round in relation to overall fiscal policy.

The Convener: My point is that it is not very helpful for the Treasury to set a GDP deflator that clearly does not take realistic pay demands into account.

Ben Zaranko: The GDP deflator is a measure of domestic inflation that has been used for a long time for all sorts of things. It is used in relation to forecasts for real GDP versus nominal GDP and for measuring how much economic activity we have versus inflation. There are good reasons for the Treasury to use one economy-wide measure, so that all public services are treated equally.

In normal times, CPI and the GDP deflator track each other fairly closely. This is an exceptional period, but I do not think that the conclusion should be that we toss out and entirely abandon that measure of inflation. Some flexibility is required, with the Treasury recognising that cost pressures on public services might be greater than what is suggested by the headline figures. Particularly when we take into account potential pay awards, flexibility is what is needed—we should not throw the baby out with the bath water.

The Convener: Exactly. That is the point that I was trying to make, but you have made it much more articulately than I did.

I thank our witnesses for their excellent contributions and for answering all our questions, and I thank my colleagues round the table for their contributions, too.

That concludes the public part of today's meeting. The next item on our agenda is consideration of our work programme, which we will discuss in private.

11:54

Meeting continued in private until 12:07.

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