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Finance and Public Administration Committee

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Wednesday 9 September 2026

Session 7

The Scottish Parliament
Pàrlamaid na h-Alba

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FINANCE AND PUBLIC ADMINISTRATION COMMITTEE
4th Meeting 2026, Session 7

CONVENER

Clare Haughey (Rutherglen and Cambuslang) (SNP)

DEPUTY CONVENER

*Alan Brown (Kilmarnock and Irvine Valley) (SNP)

COMMITTEE MEMBERS

*Liam Kerr (North East Scotland) (Con)
*Michael Marra (North East Scotland) (Lab)
*Liam McArthur (Orkney Islands) (LD)
*Kim Schmulian (Glasgow) (Reform)
*Pauline Stafford (Bathgate) (SNP)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Professor David Bell (University of Stirling)
Stephen Boyd (Institute for Public Policy Research Scotland)
Professor Jim Gallagher (Royal Society of Edinburgh)
Alison Payne (Enlighten)
Dr João Sousa (Institute for Fiscal Studies)

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Finance and Public Administration Committee

Wednesday 9 September 2026

[The Convener opened the meeting at 09:30]

Decision on Taking Business in Private

The Deputy Convener (Alan Brown): Good morning and welcome to the fourth meeting in session 7 of the Finance and Public Administration Committee. I have one apology for today's meeting, which is from the convener, Claire Haughey, so the witnesses have the joys of me convening the meeting.

The first item of business is to decide whether to take item 3 and future items to consider evidence heard during pre-budget scrutiny 2027-28 in private. Is that agreed?

Members *indicated agreement*.

Pre-budget Scrutiny 2027-28

09:30

The Deputy Convener: The next item is to take evidence in the committee's pre-budget scrutiny 2027-28, which is about the affordability and sustainability of Scotland's tax and spending plans. I welcome our two witnesses: Professor David Bell, professor of economics, University of Stirling, and Dr João Sousa, senior research economist, Institute for Fiscal Studies.

I think that youse are well seasoned at being before the committee, but I remind you not to worry about turning on your microphones during the session, because those are controlled automatically by broadcasting. If you do want to come in during a discussion, please raise your hand to indicate to the clerks and we will try to facilitate that as best we can.

We move to questions. I call Michael Marra for the opening question, please.

Michael Marra (North East Scotland) (Lab): It is nice to see you both this morning. I will start with issues of fiscal sustainability. I thank you both for your submissions. Professor Bell, you said in yours that the savings that the Government has identified

"remain targets or plans rather than demonstrated, recurring reductions in expenditure."

Would you like to set out a bit of context for us as to why that is your view?

Professor David Bell (University of Stirling): The programme for government as set out thus far identifies several areas in which savings might be made, but we are now at the stage where we need to be much more precise about where those savings can be made.

There are acknowledged, serious dangers that we will exceed the current plans around issues such as public sector pay and spending on welfare, which might jeopardise the achievement of the savings that are currently proposed. Without a more precise explanation of how those savings will be achieved, the danger is that we drift into making savings in a way that is not beneficial for service provision because they are, in effect, being made at the last minute to achieve the budget balance that the Scottish Government must achieve.

Michael Marra: Do you generally agree on the issue of sustainability and lack of clarity, Dr Sousa?

Dr João Sousa (Institute for Fiscal Studies): I agree with what Professor Bell said regarding the lack of detail. We have noted in our submission that about two thirds of efficiencies are meant to come from the health and social care portfolio, but a lot of that is meant to come from national health service boards. Although I understand that there is some discussion as to what form the reorganisation of the NHS might take, it is still a set of stretching targets. There is no guarantee that this will happen, but the fact that Audit Scotland highlighted that NHS boards have mostly failed to meet less stretching targets than those ones informs what you might expect to happen in the next few years.

The problem is that, unless you can find funding from other areas, which is possible, you might end up in a situation where you just cannot do as much as you would want to, which is not ideal. That is important.

Another thing that we highlighted is that becoming more productive does not necessarily mean that cash will be released and can be saved. For example, you might think that the NHS could become more productive at doing elective surgery, but if there are no controls to ensure that it does not fill that time with additional activity—which might be demanded by the population and might therefore seem like a good thing—it will not make the bankable savings that make the financial sustainability sums add up.

Michael Marra: On that point, you mentioned savings in the NHS. In session 6, the committee found it difficult to get clarity about how those savings pertain to the deficit. There was talk about those savings being reinvested in health boards, most likely to try to meet the 26-week waiting time target, and about other savings being returned to the front line. Is there clarity about whether those savings should contribute to reducing the overall £5 billion deficit or whether they should be used to fund the expansion of provision?

Dr Sousa: The health and social care area is the one in which there is least clarity about where savings will come from. It depends what the Government's priorities will be. It is within the Government's purview to decide to do that, but those decisions are not easy and none of them comes without trade-offs. If you want to spend more to meet particular targets on health, that funding has to come from somewhere. Just spending more without making a trade-off about where the money comes from will not necessarily deal with the issue of financial sustainability.

Professor Bell: Can I add to that? I make a point in my paper about demand-led services, including, to a certain extent, health and social care but also the welfare budget. It is difficult to manage a more or less fixed budget when some elements are in effect demand led and when eligibility determines how much you spend. If the demand-led elements of that budget increase, the consequence is that other parts of the budget must decline.

Michael Marra: You have both mentioned the First Minister's presentation to Parliament last week of the programme for government. There was a lot of discussion about public sector change, particularly about reform to councils and to the number of NHS boards. You have both raised the issue of the NHS. Is it clear to you whether those plans have been devised to deliver savings to the overall budget or whether they are about delivering better services? Any discussion of the £5 billion deficit was pretty absent from the presentation to Parliament.

Professor Bell: I agree that we do not yet have sufficient detail about how those plans might be taken forward and what the geography of the new health boards will be.

Michael Marra: Can I push you on one point? Given your experience as a long-term observer of these processes, is there a risk about the up-front costs of reorganisation? For example, there were significant up-front costs for a number of years when Scotland moved to having a single police service. Might we see any reorganisation costing money rather than saving it?

Professor Bell: It could increase costs in the short-term, because you cannot significantly reorganise a workforce without incurring costs. They will come in different forms, but any major reorganisation always involves some up-front costs.

Dr Sousa: That is not necessarily a reason not to do it. If you think that the benefits of running the service in a more streamlined way will outweigh the costs further down the line, that is a reason for going for it, but, naturally, it would involve both cost and time.

It is important to note that we are already part way through the public sector reform programme. It is not possible for it to happen overnight and it is unlikely that it will deliver savings immediately. Again, that is not necessarily a reason not to do it, but when the savings will be delivered is something to bear in mind, because the budget balancing has to happen across the piece. I would not focus too much on the £5 billion in the medium-term financial strategy, because there have clearly been plans subsequent to that that have reduced the spending plans. There are still pressures on top of that, but there has been a recognition of the situation. In a sense, the MTFS was a pre-prioritisation document, listing all the pressures that might happen; then, the spending review said that the funding would not be there to match it so this is how much the Government plans to spend, which is significantly less per year. That would be the case in all situations, because the deficit cannot materialise.

Michael Marra: On the path to savings, is what you have heard in the past week commensurate with the scale of the challenge on pace? In the coming couple of years, we will have a significant block grant adjustment and a really constrained fiscal settlement. We know the shape of that and—to some extent, through the fiscal sustainability delivery plan—we know the shape of where we have to get to. Last week, we heard two essential parts of the conversation about a significant change in health board reform and a pretty broad and woolly conversation about local authority reform. I am not one to judge either of those things; my question is about the path to sustainability and whether it will give us the pace that is required to achieve the outcome of meeting the budget deficit.

Professor Bell: The signals that I have been able to detect thus far do not really indicate that we are on that path at the moment. I already highlighted public sector pay, which will be a very difficult issue, given the way in which settlements have already been made and the commitments that are associated with those settlements. The trajectory that we might expect public sector pay to take is not commensurate with the savings that we are thinking about.

Dr Sousa: On the question about the path to savings, 2027-28 looks like a really tough budget. There is the reconciliation next year; there is the fact that the block grant will fall in real terms; and there are the public sector pay policy pressures that are already built into the existing pay policy, plus the inflationary pressures that will erode the value of the settlements that have already been made. There might yet be additional funding from decisions taken at United Kingdom Government level, although we cannot know that for certain.

Next year looks really difficult and, if reorganisation costs come at a time when the budget is already being squeezed, that makes what was a pretty difficult task even more difficult.

Michael Marra: On the lack of an MTFS this year, Dr Sousa, you suggest in your paper that we could instead be looking for an update on the fiscal sustainability delivery plan. Would that give us a better insight into whether targets have been met? Should the committee pursue that?

Dr Sousa: An update to the FSDP—and the savings that have been realised in the plan, for those that had not yet been realised—would be helpful in that regard, yes.

09:45

The Deputy Convener: Kim Schmulian and Liam McArthur have indicated that they wish to come in. I will let Liam in on the back of that response, and then Kim can ask her questions.

Liam McArthur (Orkney Islands) (LD): Good morning. I will follow up on Mr Marra's earlier question on the up-front costs of the restructuring. Mr Marra fairly pointed to the experience in Police Scotland, and college regionalisation leapt to my mind. The Government's consistent argument was that the restructuring would release efficiencies that would pay for it. Those efficiencies were only ever going to be realised two, three, four or five years down the line. Is there a way in which the Government can be clearer about the timeframe for releasing those efficiencies, if its expectations are that they will cover the costs of the reform process, in whole or in part? Is there a way for the committee to put pressure on the Government to be clearer about the timing?

Professor Bell: I think that the committee should try to get as much information as possible from the Government about that. Such reorganisations necessarily involve a lot of transactions and conversations between the relevant parties to identify how the savings will be achieved. That cannot be done overnight. Although one might want to get information as quickly as possible, that will not really be possible, to some extent. The committee should be trying as hard as possible, but major reorganisation is undoubtedly a complex and time-consuming exercise.

The Deputy Convener: I have something to ask on the back of that, before I bring in Kim Schmulian. As has rightly been pointed out, there will probably be up-front costs associated with reorganisation. Shrinking the workforce will inevitably involve some redundancy payments for some people, which are further up-front costs. Does the fiscal framework make that more difficult? In effect, it is possible to borrow only for reconciliation and budget shifts. As you said, Professor Bell, much spend is demand led, and it is therefore much harder to set aside chunks of money that will bring efficiencies at the back end. Would that be a correct interpretation?

Professor Bell: Having significant demand-led elements of the budget alongside a relatively small borrowing availability will always make the management of budgets difficult.

Dr Sousa: It is fair to mention the lack of ability to borrow up front, which relates to a wider point about the fiscal framework and whether there is a case that the Scottish Government could be allowed to borrow to address particular pressures. You could make a case that being able to do so would ease the transition. That is not currently available, although that does not mean that the Scottish Government does not have any powers to smooth things over time. If you are going to do reorganisation within that kind of framework, it probably means that you have to leave yourself a gap that cannot be used to deliver other services during the particular year—otherwise, things will add up.

Professor Bell: I am aware that the head of Audit Scotland made the case the other day that we should have whole-of-government accounts for Scotland, which would include all the assets as well as the cash situation of the Government. Having whole-of-government accounts might help us to identify areas where cash could possibly be generated by using an asset base to generate income, rather than having to rely exclusively on borrowing.

Kim Schmulian (Glasgow) (Reform): Gentlemen, there are two parts to my question, the first of which relates to information that I have been given by previous members of this committee. They have said that the information in the medium-term and outturn reports does not give enough clarity, because it does not give any detail on shifts between departmental budgets. To what extent do you think that that is an issue, and to what extent do you think that we should be pushing the Scottish Government to provide more clarity in that regard?

Secondly, going back to Mr Marra's point about health, I read recently that a lot of the health budget goes out the door to services provided through buy-in contracts. So, when it comes to trying to save money in the health budget, how much flexibility would the Scottish Government immediately have, given that constraint?

Dr Sousa: With regard to the information that is provided in budgets, the Scottish Government is organised into portfolios that have boundaries that I would describe as more porous than those in, for example, Whitehall departments. As a result, it is easier to transfer things across. There is a case to be made for some flexibility in that respect, but in both my current and previous roles, I have made it quite clear that I think that budgeting should be done on the basis of where things are going to end up over the course of the year and that transfers between portfolios should be limited to genuine reallocations of money relative to what was previously thought would be spent, instead of putting, for example, education spending into the health budget that then gets transferred to the education portfolio and is transferred again to pay for, say, the education of doctors and nurses or social care allocations. The money might go into the health and social care portfolio, but it then gets transferred through the general revenue grant from the local government portfolio and then to local authorities. That kind of pattern makes it really difficult to understand up front where things are headed.

Obviously, it is our job at the IFS to look at that sort of thing, but we should not be required to do all of this rebaselining to try to figure out where we think things will eventually land. Ultimately, the Government has better information on that, and we think that it should make that information public and thereby make it easier for us to compare things.

Professor Bell: I completely agree. Ultimately, you want the budget to reflect what money is being spent on what service. Local government is a good example of that: a very significant proportion of the budget goes into social care, but if you look at just the local government line in the budget, you will not actually pick up how much of its budget is being allocated to social care and what pressures on the services being provided to the Scottish public are coming from that particular direction.

Dr Sousa: The Scottish Government bases calculations on how much it wants to fund in terms of uplifts to pay, for example, but although that money might notionally be thought of in that way, in reality it gets transferred as a block grant to local government, which then has that responsibility. After all, it is local authorities that have to respond to pressures and provide services, so they have to reallocate things. As a result, there is no direct link between how much money gets put into the social care line of the Scottish budget and how much actually gets spent on social care by local authorities, because they are the ones who get to decide that, and they have to respond to local pressures. That is their statutory responsibility.

Professor Bell: We must be cognisant of the fact that local government is a democratic institution with some ability to determine its own budget. However, if the Scottish Government provided in its documents at least an indicative budget allocation, that would give a clear indication of how much finance would be allocated to services used by the Scottish public.

Kim Schmulian: Other European countries are much better at this than we are. Some countries have managed to create a system in which they can follow the pound or the euro and see exactly where money has been spent. Is that an ideal scenario that we should be pushing for in Scotland, or will that never happen?

Dr Sousa: I will not comment on other European countries, because I am not clear enough on the details of what they are doing. However, I think that everyone agrees that knowing what has been spent is important. It can be difficult to trace revenues, because they are fungible—once a pound goes in from one source and another pound goes in from another source, they are indistinguishable. Some follow-the-money calculations rely on assumptions about what would happen if revenues were not spent as intended. However, transparency in expenditure is good.

Professor Bell: I am all for as much transparency as possible. However, I remember that, when I was an advisor to the committee, we were constantly searching for ever-greater levels of detail on spending plans, and I was not entirely sure at the end of the day whether that information was of huge value to the committee, in the sense that it could not manage to effect change based on that very detailed information.

We could do a better job in providing budgetary information, but we could also do a wholly better job in thinking about outcomes. Ultimately, the budget aims to provide the people of Scotland with the services that they wish as efficiently and effectively as possible. In order for that to happen, we must understand the outcomes that people want and measure them clearly. We are not all that good at doing that. We have the national performance framework, which includes a set of aspirations and metrics on where we should be going in relation to tackling poverty, addressing climate change and so on, but there is a big gap between the committee's activities and the outcomes that are achieved for people.

Kim Schmulian: Do you agree that, if there were more clarity on spending, that might enable Opposition parties to draw up alternative budgets, which would push the Scottish Government towards focusing on outcomes?

Professor Bell: There is certainly the power to do that, but it would involve a huge amount of work.

Another recurring issue that has not yet come up is the budget timetable, which is so short that the ability to produce a detailed alternative budget is heavily constrained.

Kim Schmulian: I am hoping that, in due course, artificial intelligence might help with that. I think that my colleague has a question on that later.

10:00

Liam Kerr (North East Scotland) (Con): Good morning, panel.

Professor Bell, you state in your written evidence that it should be

"growth in earnings and employment, rather than simply higher tax rates"

that drive the economy. You suggest that we need to evaluate the

"increasingly large differences between Scottish and rest-of-UK … tax rates … according to their … behavioural effects on migration, hours … and the location of high-skilled employment."

I have a few questions on that.

The Scottish higher-rate tax threshold is being frozen again, meaning that wage growth will pull more middle-income earners into the 42 per cent rate. The Scottish Fiscal Commission says that more than 26 per cent of Scottish taxpayers pay the higher rate or above, compared with about 22 per cent in the rest of the UK. To what extent is Scotland now relying on fiscal drag rather than genuine growth in earnings and the tax base? Is that situation sustainable?

Professor Bell: That is a very difficult question to answer. There is very noticeable fiscal drag, both at the Scottish and UK levels, due to decisions that have been made by the chancellor. The key issue that needs to be addressed is the behavioural effects of that level of fiscal drag. Those are very difficult to assess. In my opinion, the evidence is mixed.

An important issue, which underlies your question, is that Scotland's budget is now determined by its performance relative to the rest of the UK. The biggest element of revenue that the Scottish Government raises is income tax and, effectively, if Scotland's income tax per head grows less rapidly than that in the rest of the UK, our net tax position will be negative. Therefore, there is pressure that was not effectively there prior to 2016 as a result of the Scotland Act 2016, which introduced additional powers on tax on the one hand and on welfare on the other, which we might come to. However, perhaps it has not been fully appreciated that relative growth in Scotland is vital to the health of the Scottish Government's budget.

Dr Sousa: Because of the progressive nature of the income tax system, people who earn a lot more pay a lot more tax, and the comparator geography, which is England and Northern Ireland, is largely driven by London and the south-east. It has many more additional-rate taxpayers, as they are known in the rest of the UK; in Scotland, they are known as top-rate taxpayers. That means that, even if earnings in both geographies—in Scotland and in England and Northern Ireland—grow at the same rate, the gap between the two naturally widens, because more income tax is raised per person at the top rate.

To maintain the same gap, you either need faster growth in Scotland, because of the lower yield per taxpayer, or higher tax rates. Effectively, we have higher tax rates, which, in some sense, make up for that. Indeed, they raise a bit more revenue.

Some of that effect has come about through freezing the higher-rate threshold, which has been done at UK level as well, but at a lower rate. It is essentially the situation that existed UK wide pre the Philip Hammond reform to increase the threshold from £43,000 to £50,000—that reform never happened here, and now the threshold is frozen in both geographies.

Professor Bell: To add to that, it is income tax per person, so it is over the whole population, including children and older people. When you have a greater proportion of older people who are, in general, not adding to the income tax revenue, that depresses the income-tax-per-person number for Scotland relative to England and Northern Ireland.

Dr Sousa: And it is the per-person calculation that goes into the block grant adjustment.

Professor Bell: Yes—that determines the block grant adjustment, which is what is taken away relative to the income tax that we generate. The difference between those two is called the net tax position, and that is the thing that suddenly had a £700 million hit a couple of weeks ago. The income tax data is delayed by a couple of years, because income tax is collected from the self-employed well after the event; that is why the reconciliations take place considerably after the end of the fiscal year.

Liam Kerr: I am grateful for that information. Sticking with the constitution of the tax base that you have just outlined—you talked about the older demographic, for example—I note that the Office for National Statistics has said that 45 per cent of workers earning £50,000 or more are engaged in hybrid or remote working. The ONS contrasts that with 8 per cent of those earning under £20,000, so it concludes that managerial—and professorial—occupations are most likely to engage in hybrid working. If that is correct, is there any risk that those who have a Scottish job and earn more are more likely to live and pay tax elsewhere in the UK?

Professor Bell: It is possible, but I do not think that there is any clear evidence of that being the case, because that information has not been collected in a systematic way.

Dr Sousa: I do not want to say that it is not a risk—obviously, it is—but I do not think that there is data to suggest that that is happening on a scale that would affect tax revenues in a big way.

Liam Kerr: I do not question that at all, other than to note that there is a report this week that, across seven Scottish health boards, the number of staff who are registered at addresses outside Scotland has risen by 56 per cent in the past three years. Is there any evidence that that is connected to the tax rate?

In conclusion, given what you have said about the lack of evidence, is that something that the Scottish Government ought to be investigating alongside the growth of remote working and the impact of fiscal drag? Should the 2027-28 budget accommodate those facts?

Dr Sousa: I have not read the report—56 per cent sounds like a large number, but it might be from a very small base. I do not know what that refers to, and I think that we should be cautious about seeing it as indicative of something that is material to the broader income tax revenues. That does not mean that it should not be looked into, and the Scottish Government should definitely have an interest in ensuring that the right tax is paid, as should HM Revenue and Customs, which collects the tax on the Scottish Government's behalf, so I would leave it to them to do anything, if anything needs doing.

Professor Bell: I agree. I wonder whether those people are on the books of health boards and are being brought in for very short-term contracts to tide over absences, for example. I do not know. That could certainly be followed up.

One thing that is not given enough attention is whether, and to what extent, people do not come to Scotland because they are told that Scotland has a high-tax regime relative to the rest of the UK. That is a very difficult thing to measure, but it may well be that general arguments relating to tax are being made about the positioning of employees and so on that were perhaps not being made prior to the differences in rates. It is incredibly difficult to draw accurate evidence on that, however.

Liam McArthur: I have a couple of questions. Professor Bell, you were explaining some of the problems created by the need for reconciliations. We picked up this topic with Professor Roy and Scottish Fiscal Commission colleagues last week. Intriguingly, they suggested that their estimates of tax revenue had become more accurate, although the scale of the reconciliations was bigger than ever, and that was anticipated to be a factor in future.

Do you have any thoughts on how the Scottish Government can better manage that lack of certainty? Will it require adjustments to the fiscal framework, or is there anything that can be done in the interim? What impact will it have in trying to achieve the budget savings that the Government is seeking to achieve over the next two or three years?

Professor Bell: It harks back to what I was talking about earlier: the issue of an increasing proportion of the budget being demand-led while having forecasts that may have significant errors associated with them, even if they are smaller. The total amount that we are talking about is around £18 billion, so a 2 per cent or 3 per cent error either way, which is certainly not unknown in forecasting terms, makes quite a bit of difference.

You might perhaps think about where your current borrowing position is and what action you could consider taking in anticipation of the kind of significant reconciliation that we have seen. How do you buffer that kind of change—which will have a significant effect on next year's budget?

Dr Sousa: Regarding forecasts, the situation is partly a product of the fact that there are two institutions that do forecasts. They forecast different things, but the things that they forecast have to be netted off.

The Scottish Fiscal Commission forecasts income tax revenues. The block grant adjustment is forecast by the Office for Budget Responsibility. Each of those organisations is trying to do its best forecast of the things that it has been asked to forecast. The Scottish Fiscal Commission has been asked to forecast the Scottish economy. The commission gives its best view, and it makes a particular judgment about where income tax is likely to go. The Office for Budget Responsibility has tried to forecast growth in earnings for the UK economy as a whole. It takes a more pessimistic view—that is perfectly reasonable. What matters for the Scottish budget is neither one nor the other in isolation, but the two put together. The fact that the Scottish Fiscal Commission has a more optimistic view—not of Scotland in particular, but of earnings growth for the whole economy of the UK, which manifests itself in higher growth in Scotland than is being implied by the OBR—means that that gap has grown in the forecasts. Even if the Scottish Fiscal Commission were getting more accurate—you could say that, in some sense, it has been vindicated by the fact that the growth in earnings has been faster than was predicted by the OBR—that would not change the fact that the net effect is what matters for the Scottish budget.

10:15

If there is a negative reconciliation—the gap is too big and the money was spent previously—that money is clawed back in arrears two or three years later. The view of the IFS is that the gap looks too big in the forecasts, which is why we think that, all else being equal, there will be negative reconciliations in the next few years. It is important to look forward and think about how we can prepare ourselves if that happens.

David Bell mentioned the borrowing position. Using the reserve as a way of managing the position is good. Some reforms of the fiscal framework have led to genuine improvements. There have been increases to the amount of borrowing that can be done for these purposes. There could be a case for not having annual borrowing limits, but we think that there should still be some sort of cap, because otherwise the Government would, inevitably, just delay the pain until everything was due.

The position is difficult to manage, but it ultimately reflects the fact that the forecasts were too optimistic in relation to the gap between the two figures. That needs to be taken into account.

The reconciliations are one-off pots of money every year, but we do not know how they will relate year to year, so we cannot predictably rely on the reconciliations being positive. In the past few years, the Scottish Government has used those pots of money to finance not one-off spending but recurring spending—for example, increased pay awards, because of market conditions, or the expansion of particular social security payments. If one-off funding is used for recurring spending and the reconciliations eventually turn negative, the Government must find some other way of funding the recurring spending. Otherwise, the numbers will not add up.

Professor Bell: Absolutely. That approach does not make sense, because we are talking about one-off amounts of money. If the reconciliations were completely randomly distributed, they would average out to zero, so using them to fund long-term commitments and recurring expenditure would be a dangerous path to go down, because the Government would, on average, get nothing from the reconciliations.

The Deputy Convener: Dr Sousa, you mentioned the reserve and borrowing powers. Is there an issue with the reserve not being big enough to deal with reconciliations and other matters?

I have been thinking about something else. We need to find recurring savings. The previous medium-term financial strategy talked about £2.6 billion of recurring savings by the end of the parliamentary session. Am I right in thinking that, if the Government managed to find £1.5 billion of recurring savings early—that might be somewhat optimistic—it could not put all that money aside in the reserve, because there would be a clawback? That makes it even more difficult to smooth out our savings in an incremental manner.

Dr Sousa: The reserve limit is about £750 million.

One of the things that happened in the last review of the fiscal framework, and which I think was helpful, was the abolition of the annual limits on how much can be put in and drawn down. When it comes to smoothing things out, I would view the reserve in conjunction with the borrowing powers that are already in place for reconciliation errors. For example, the Scottish Government can borrow nearly £700 million to deal with such things, which means that it will have to borrow for nearly all the reconciliation next year. Of course, interest will have to be paid on that, too.

However, if you had some money in the reserve to pay for that, you could smooth that out a bit more than if you did not. You can understand why the cliff edges and the clawbacks were put in, but they are not necessarily great design mechanisms, because they encourage people to spend the money on whatever rather than on what would bring the most value, so that they do not lose it.

I would think of savings more in the round, because the Scottish Government will not necessarily be saying, "Oh, we'll just put the money in the reserve if we get these savings." We should be thinking in terms of the funding that is actually needed to cover all expenditure, because that takes you to the point where you might think, "Well, we're spending £1 billion less, so we don't have to raise as much tax."

Therefore, it is not just a matter of banking all those savings. Under the fiscal framework, if you do not need as much revenue to pay for what you are spending, you have an incentive to not necessarily raise as much revenue.

Professor Bell: You could look at cutting taxes, for example, which might have beneficial effects on the kinds of income-tax-per-head issues that we were discussing earlier.

The Deputy Convener: Of course, with reconciliation, there is a two-year lag before you see any positive or negative effects.

Dr Sousa: That is true, but we would see the forecast effects. Only if the forecast turned out to be wrong would there have to be reconciliation. Therefore, you would see those immediate effects, but there would be a reconciliation down the line to ensure that the forecasts aligned with what actually happened.

The Deputy Convener: I was exercising my prerogative by jumping in there, Liam. Can you make it quick?

Liam McArthur: I will leave Liam Kerr to cover the bond issue that probably flows from some of what you have been saying, Dr Sousa. I was intrigued, though, by the comment in the IFS submission that

"Scotland's tax and economic strategies have traditionally focused more on how economic growth can boost the tax base, rather than how the tax system can best support growth."

Some of what you were saying with regard to the response or reaction of the Government to the presence of an additional reserve pointed to an alternative strategy that it might put in place, and I would be interested if you could flesh that out a wee bit.

Dr Sousa: There is the tax that gets raised, obviously, but the way in which it gets raised matters, too. It has become a classic IFS talking point that we think that things like the land and buildings transaction tax and other property transaction taxes are pretty bad taxes. They stop people transacting and moving home when that sort of thing would be beneficial for everyone, and you could have a different property tax that might raise as much money and be less distortionary to the economy. Thinking about tax design is really important in that respect.

Even in the income tax system, which we have been talking a lot about, there are quite weird design accidents—I would not call them design choices—such as the very high marginal tax rate that employees who earn a salary between £43,000 and £50,000 pay because they are subject to the higher rate of national insurance contributions and income tax. That means that you end up with a rollercoaster income tax schedule that does not really pass the good tax design test.

Easing those distortions would support more economic activity, which would be good as a whole, period, even if it did not raise any more tax revenue, because people would be better off on average. However, encouraging even more growth might get you some rewards. I am not saying that tax cuts would pay for themselves—I do not think that we are anywhere near that kind of situation for most taxes—but they could support growth through the design of the tax system.

Professor Bell: I am a convert to the IFS view of tax design. It really all stems from the Deaton review of taxation in the UK. Angus Deaton, a good Scot, highlighted problems with the taxation of property generally. We now have LBTT, council tax, mansion tax and, in some parts of the country, a second home premium; that, as I said, is creating very strange incentives that are not consistent with improving economic activity overall in the country—obviously, some of that applies to the rest of the UK as well. Quite a long time ago, one of the early MSPs, Andy Wightman, worked a lot on land value tax in Scotland, and I have updated that work a bit. In order to possibly raise the same amount of revenue at the same time as doing much more to encourage economic activity, we really need to encourage the Scottish Government to start thinking seriously about redesigning the way in which property is taxed in Scotland.

I also completely agree about the structure of the income tax schedule. When you combine it with national insurance, it looks like a camel with two humps; it does not make sense at all. In particular, the marginal tax rate that people in that £43,000 to £50,000 band are paying is extremely punitive.

The Deputy Convener: My colleague Pauline Stafford has been very patient. If you do not mind, Pauline, I will ask a couple of follow-on questions and then bring you in. I appreciate your forbearance.

I want to touch on what has just been raised in response to Liam McArthur’s questions on council tax and LBTT. It struck me that we are still using council tax based on 1991 valuations. Many people are now buying houses whose valuations are older than the people moving into them. It has always been a thorny political issue, so there is a question about how we would reach agreement on it, but what would a fairer council tax system look like? How could we get politicians to coalesce around a solution that would fly through Parliament and stimulate economic growth and activity, without complaints about winners and losers?

Dr Sousa: If we and all of you knew that, it might have happened already—as with the old joke about economists who think that, if something were a great idea, it would have happened already.

You are right about the valuations. However, the point is that council tax is not about the valuation itself, because you are simply placed in a band; it is about how much your property is worth relative to other properties.

10:30

There has been a lot of regeneration of places that were previously, in 1991, not good places to live relative to the rest of Scotland. If properties in those places were simply revalued, their owners would be the biggest losers in the process.

Thinking about where things should end up probably tells you how you might structure the transition to a new system. It might be that it costs money in the short run, which is a challenge, but that is how, for example, business rates or non-domestic rates revaluation happens. You do not immediately require people to jump from the previous valuation to the new one; you give them transitional relief. We have successfully revalued non-domestic rates many times—many more times, in fact, than we have revalued council tax.

With council tax, the system is now so bad that, in some sense, it is hard to imagine how a new system could be worse. The further we get into that—

The Deputy Convener: I am not hearing the silver bullet that I am looking for.

Dr Sousa: No, but the further along you go, the more obviously unfair it becomes and, therefore, the more apparent the opportunity for reform that improves things, even if it is not a silver bullet or the perfect tax. It also becomes easier to get to a place where things are at least better.

Professor Bell: I was involved, at least 20 years ago, in one of the early attempts to reform council tax, which was essentially about changing the ratios applied to the bands. It never saw the light of day—it just did not fly politically at all.

It seems to me that a key issue now is geographic variation. If you do a casual evaluation of what has happened since 1991, it is clear that some parts of Scotland have suffered economically relative to others that have prospered. Those that have suffered are still paying relatively high council tax, so that is not a reasonable reflection of the current value of their property. Equally, some are paying relatively low council tax, which does not reflect the value of their properties.

The issue of valuation, which seems to be much less of an issue in relation to non-domestic rates, has not—for political reasons, I guess—been successfully addressed since well prior to devolution.

Pauline Stafford (Bathgate) (SNP): I start by drawing attention to my entry in the register of members’ interests, as I am an elected member at West Lothian Council.

The discussion has moved on a little, but I would like to come back to the point about the risks to devolved tax revenues that Mr Kerr raised. We talked a bit about some Scotland-specific risks. In your submission, Professor Bell, in response to question 7,

“What are the main risks to devolved tax revenues?”,

you said that

"The largest risk is relative economic performance",

and stated that that

"is a function of the Fiscal Framework."

In a general sense, therefore, is the fiscal framework still fit for purpose and able to accommodate the larger risks that come with our growing fiscal autonomy?

We talked a bit about Scotland's faster-ageing population. Thinking about other things that are not within our power, such as immigration policy, are there any other Scotland-specific risks that would affect tax revenues?

Professor Bell: The fiscal framework is essentially about giving Scotland the power to raise its own taxes, and that replaces money that used to come through the block grant, so there has to be a reduction in the block grant. It is how those two things are lined up against each other that determines the net tax position, to which we both referred earlier.

There were a whole variety of options, and I was quite involved in the discussions on how that reduction in the block grant would be determined. We have touched on that; income tax per head is the key metric. For a while, it was just going to be income tax, but that was deemed not to be beneficial for Scotland because of the faster-growing population in England, which in itself adds to income tax revenues. It was therefore brought back to income tax per head. Those are extremely arcane calculations, which end up in the reconciliations that we were discussing earlier.

Wales has gone for a potentially less risky method of determining its block grant adjustments. It has taken over income tax, and it was recognised—probably due to the weakness of the Welsh economy relative to the Scottish economy—that it could not take on a higher level of risk. It is difficult to escape the logic of needing to make a reduction; the question is how to design that reduction. Also, it seems incredibly difficult to get across to the population why that is required and how the block grant is adjusted. It is a very arcane calculation.

Dr Sousa: The fiscal framework basically combines two elements. There is more power, but with more power comes a greater share of the risk that comes with raising revenue. That is a fair trade-off. You cannot just have the good things. If a devolved Government is to be given the power to make big decisions, it must also share some of the associated risk. That seems like a principle that should be applied.

As David Bell pointed out, there are lots of detailed calculations and different ways to design it. Some are more beneficial to the devolved Governments; some are less beneficial. In some sense, those approaches are trying to get at the same thing: what would have happened otherwise, if there had not been the transfer of powers? Given how devolution works in the United Kingdom, that would probably have to remain. That does not mean that you cannot improve things in the fiscal framework, particularly regarding flexibility. There is a case for that. There is also a case for doing other things instead of indexing.

We have done the first step, in that the limits for borrowing and the reserve are no longer in cash terms—which is great. They are now indexed by inflation. Because revenues normally grow faster than inflation from year to year, we might expect them to decrease relative to spending and revenue-raising powers. There is a case for, for example, indexing that to revenues.

Those are tweaks to the fiscal framework, however, rather than massive overhauls of it.

Professor Bell: The outcome of the fiscal framework that was agreed was essentially a compromise. In effect, the Treasury wanted another potential way of determining the block grant adjustment, which would have been more difficult for Scotland fiscally. The income tax per capita method that was eventually agreed was less so but, perhaps because of that, the borrowing powers were less extensive, given the kinds of swings caused by reconciliations and so on. It becomes difficult for the Scottish Government to manage the budget within those parameters.

Pauline Stafford: The Institute for Fiscal Studies said in its submission that, because of sectors such as oil and gas and financial services, we are probably more exposed, and small fluctuations can make a bigger difference. Will you expand on that?

Dr Sousa: That relates back to my point about high-earning taxpayers having disproportionately large effects on how much income tax is collected. That concerns oil and gas. We are exposed in relation to financial services, which have not been doing brilliantly, but have not been doing too badly either. Oil and gas has been doing pretty badly over the past decade. That means that we have fewer high-paying taxpayers, and their earnings have gone down in real terms. We are collecting relatively less from that sector than previously. Because that sector raises quite a lot of income tax, if it does not perform well, that depresses the revenue that we get in Scotland. One taxpayer earning £100,000 pays a lot more income tax than two taxpayers earning £50,000.

Pauline Stafford: On a final point about migration of high earners, which Mr Kerr mentioned, you said, Professor Bell, that you would be interested to know how many people are put off moving here because of the rhetoric about Scotland being a high-tax regime. Is there any evidence on the motivations of taxpayers on the other side of the equation? Tax might not be their only priority; they might also be concerned about quality of life, wellbeing and other benefits that are available. Is there any data to suggest that that is the case?

Dr Sousa: It is so difficult to know. We are trying to work on revealed preference. People might say, "Yes, I'm really concerned about that," but they might still move anyway, or they might not move away, even if they are concerned about it. We want to determine it on the basis of what people do rather than what they say they will do. That is really important in determining how people respond.

There is evidence that there is still migration from the rest of the UK to Scotland. That pattern does not apply only to Scotland; it applies to Wales as well. It is part of a broader pattern of a lot of people moving to London early in their career, and then moving outwards. People also come to study in Scotland, for instance. That looks like it is part of a broader pattern. It is not as if there is no migration, as you describe it. The question is what it would have been in the absence of the change, and that is the tricky part. We have limited data on those people.

An HMRC study looked into the first batch of changes to Scottish income tax. A counterfactual has to be constructed for what a given group of people with certain characteristics would have done in the absence of the change. That is so difficult to do.

Professor Bell: Interestingly, the situation in Wales is even trickier, in the sense that a much larger proportion of workers cross the border anyway. I suspect that that is one reason why Wales's ability to vary tax rates is limited.

The Deputy Convener: Time is clearly getting on, but I will continue the evidence session for a bit longer, with indicative timings. I presume that that is okay with the two witnesses.

Michael Marra wants to come in, followed by Kim Schmulian. Please try to make your questions brief.

10:45

Michael Marra: Dr Sousa, during the election campaign, the IFS said:

> "the SNP manifesto pledges additional spending—costing an estimated £1.4 billion a year by 2031-32—without credibly saying how it would pay for this."

Do you have any sight of how that spending will be paid for, and, for clarity in our examination of the budget, is that in addition to the MTFS's identified £5 billion gap?

Dr Sousa: I do not think that we have anything to add to what we said during the election campaign about paying for that. It is adding to the pressures, but it is not adding to the figure of £5 billion, because, as I said before, at the point of the MTFS, that figure was the indicative gap. Then we had the spending review, and, although I am simplifying things, the funding did not change by much. Spending was adjusted down significantly to match that funding. The spending on manifesto pledges will be on top of the spending review settlement, which, in itself, is predicated on achieving efficiencies that look as though they might be challenging. Although those efficiencies are not impossible or unreasonable to aim for, they will certainly be difficult to deliver at the same time as transforming public services. There is a multibillion pound pressure, which is less than it was at the point of the MTFS but more than it was at the point of the spending review.

Michael Marra: The sum of £1.4 billion is in addition to that.

Dr Sousa: It is additional to what was in the spending review.

The Deputy Convener: I might be being too literal about this. Politicians like round figures, and Michael Marra is talking about the £5 billion gap, but that is split between revenue and capital, is it not? Those are two very different things. We are talking about a £5 billion spending gap—we are rounding it up to about £5 billion—but that is actually going to be dealt with through two very different funding streams. Is that correct?

Dr Sousa: It is right that it is split between revenue and capital, and the amounts between the two are not very different—it was £2.5 billion for one and two point something billion pounds for the other. David Bell might have the actual numbers in front of him. Yes, those budgets are managed separately. They both need to be funded every year, so that does not take away the fact of the gap, but they are separate pressures.

Kim Schmulian: You talked about tax revenue being lost because of what has happened with North Sea oil workers. Wages in green energy jobs are not at such a high level, which ultimately means that we have to grow the tax base in Scotland, so what advice would you give the Scottish Government on doing that? What is your view, as innocent bystanders? [*Laughter*.]

The Deputy Convener: Try to make the answer succinct. We want the silver bullet that we did not get for the council tax question, by the way.

Professor Bell: I certainly think that there are opportunities that are in danger of being lost in relation to supply chains, particularly in relation to green energy. Again, it is one of those areas where a bit of spending upfront can potentially add to positive outcomes. It is a very competitive industry, and China is a huge supplier of the main elements of renewable energy, but it is an area of potential growth that we could be looking into, and there are other sectors, although I will not spend my time going through them all.

However, there are also big challenges. I am from the Highlands, and one of the challenges there at the moment is that the whisky industry is struggling. Although it is not a big employer, it is a key element of Scotland's export growth and the UK's export offering.

Dr Sousa: It could be helpful to focus on tax design, which we talked about. We could also focus on education and skills in order to help develop the skills that will be needed for the future, because helping to provide training and retraining beyond the usual school years is key. Those things are within the Scottish Government's competencies.

Essentially, we want workers to be trained as well as possible and to be matched to the best jobs that they can. Having such a match in the labour market is a key driver of productivity, and doing what we can to facilitate a transition to better matches and having a dynamic economy is part of growing the economy and the tax base.

Professor Bell: I should jump in on that point, because I have also done a bit of work on it. One of the big issues that is starting to be addressed at the UK level is people who are not in employment, education or training—NEETs. My estimate suggests that the rate of NEETs in Scotland is not that much different from the rate in the UK as a whole, which means that about 13.5 per cent of 16 to 24-year-olds are not in education, employment or training. That group is split into unemployed people who are looking for a job and those who are what is termed inactive—that is, they are not apparently seeking work.

We know from past experience that people who do not have a good entry into the labour market when they are young tend to suffer throughout their careers. Therefore, as we were saying, the provision of services to that group seems to be incredibly important, because they are the potential taxpayers of the future. I have been puzzled for a long time by the gradual decline in support for the college sector, which might have closer ties to that group than the university sector.

Kim Schmulian: Are you concerned about the additional college funding that could be provided for retraining older people? That might disadvantage the people that you have just talked about who leave school and end up on benefits, leading to an aimless later life.

Professor Bell: Those people are not necessarily substitutes—it depends on how much capacity there is in the college sector to train them. There is a good case for also training older people, because those who drop out of employment in their 50s—often for health reasons—may end up in poverty due to effectively having no pension support. I do not want to treat it as a contest between young and older workers; it is important to maintain the possibility of gainful employment right across the spectrum.

The Deputy Convener: That could almost be a stand-alone evidence session.

Liam Kerr: A suggestion that has been made to support public investment is to issue bonds. Professor Bell highlighted that that would not be free money and that it would eventually need to be paid back. The IFS went on to say that issuing Scottish bonds could actually cost more than borrowing from the UK's national loans fund. To be fair, the Scottish Government analysis suggests that it is the other way round. Dr Sousa, can you explain why Scotland might nevertheless prefer bonds? What evidence would allow you to say that they represent value for money?

Dr Sousa: To be clear, bonds are one form in which the Scottish Government is allowed to borrow for capital purposes. It can also get commercial loans and loans from the national loans fund; that basically involves borrowing money from the UK Government, which it then has to finance somehow. That tends to come at a relatively low cost. At the moment, the spread is very small between how much the UK Government pays and how much is charged to the Scottish Government—it has been larger in previous times.

Regarding the interest rate, there is some uncertainty as to what the actual interest rate would be if Scottish bonds were issued. It is not unreasonable to expect that the market will not be as liquid, and there is less of a track record of borrowing in the bond markets, so you might expect a small premium, but there is no certainty.

There are two other things that you might want to consider. One is that there is more flexibility in terms of how you can issue the bonds. For example, repayment terms might be delayed into the future—you can have what are called "bullet bonds". It is almost like an interest-only mortgage, so you pay interest all the time until the principal comes to you, and then you pay all of it. You still have to find money to roll over that debt at the end, or pay it off.

Secondly, you could see some wider economic effects. The First Minister's investor panel—this is just our interpretation of what was written in the IFS Scottish budget report last year by the chair of the investor panel—concluded that you could, potentially, meaningfully improve the engagement of the Scottish economy with bond markets. If that is the case and you can bring in more investment, even a small amount of additional efficient could pay for the additional administrative costs, if the costs are small relative to borrowing with bonds.

However, none of these things is certain, and a judgment requires to be made. You have to consider four things. First, there are the administrative costs of running the scheme. Secondly, there are the potential differential costs. You could do a trial to see whether there will be a lot of demand for the bonds. That is not cost free, but it prevents you from issuing a lot of bonds that do not get subscribed afterwards. A third point to consider is how much value the Scottish Government places on the additional flexibility in repayment terms, and the fourth is the extent to which you are confident about the wider economic impacts that having such a scheme would bring.

Liam Kerr: I am grateful for that. I would like a quick clarification, for my own purposes. How does the Scottish Government set the yield on the bonds such that they are more attractive than the interest rate on the national loans fund? Can it set that at whatever rate it wants to make it attractive to subscribe?

Dr Sousa: Normally, there will be an underwriter who will try to market the scheme, but you do not set the yield as such. The bond is issued and potential buyers bid for it, and it clears at a certain point; you do not have full control over it.

There have been cases in which countries say that they are going to issue bonds and it turns out that the scheme is undersubscribed, so they might pull it. That has costs—you have to pay for that. However, if it is undersubscribed, you might end up paying a much higher interest rate than you would want to, so the penalty that you pay for pulling out is smaller than the cost would have been.

You can have an interest rate or yield in mind, at which point you might pull the plug on it. That is why a trial could be helpful, because it helps you to gauge demand without going the whole hog and putting out a massive issuance. Nonetheless, you do not have as much control over a bond scheme. You do not have that much control over the national loans fund rates either—as we have seen, UK Government borrowing costs have increased as well, and that means that the cost of any new borrowings from the national loans fund will also have increased.

Liam Kerr: I understand—I am grateful for that information.

The Deputy Convener: I thank the witnesses for staying on a bit longer than was probably indicated, and I thank colleagues. As I said at the start, we are going to review evidence in private later on. I will be interested to find out whether we all heard the same answers from the witnesses, or whether we heard different answers or variations on them.

11:00

Meeting suspended.

11:08

On resuming—

The Deputy Convener: We continue our evidence taking for the committee's pre-budget scrutiny for 2027-28, looking at the affordability and sustainability of Scotland's tax and spending plans.

I warmly welcome to the meeting our second panel of witnesses: Stephen Boyd, director, Institute for Public Policy Research Scotland; Professor Jim Gallagher, trustee and chair of the audit and risk committee, Royal Society of Edinburgh; and Alison Payne, research director, Enlighten.

You are probably all aware of this already, but I remind you that you do not have to activate your microphones—broadcasting staff will turn them on automatically.

If it is okay with you, we will move straight to questions. I ask Michael Marra to kick off.

Michael Marra: Thanks very much, convener. I will come to the IPPR first, and I am sure that members will be careful not to scroll through Twitter—

Stephen Boyd (Institute for Public Policy Research Scotland): I knew that that was going to be the first comment. [*Laughter*.]

Michael Marra: We will all be on our best behaviour, now that the police are in.

The Deputy Convener: I thought it was you they were talking about.

Michael Marra: Not at all—innocent until proved guilty.

Although the IPPR is clear that the Government has talked about the scale of the deficit, you said in your written submission that it has failed

"to provide a coherent and credible plan for addressing it."

Will you expand on that, please?

Stephen Boyd: The medium-term financial strategy does a very decent job of setting out the scale of the fiscal challenge in great detail, and that is to be welcomed. However, the policy framework as a whole—the MTFS, the fiscal sustainability delivery plan in particular, the spending review and other documents published since—does not provide a credible and coherent plan for dealing with the fiscal challenge that the Scottish Government is going to face over the course of this parliamentary session.

The FSDP, in particular, has a lot to say about the efficiency of public services. We would agree with much of it, but again, in totality, the chances of the sum of those measures making a real dent in the fiscal gap that we are going to face by the end of the decade are vanishingly unlikely. One might welcome many of the measures on growth, but in general, there is sometimes quite wild optimism about what devolved policies can do for growth over the short term.

Finally, on the tax strand, I am sure that we will come to talk about this in more detail, but nothing in the tax section leads me to believe that the Government is thinking seriously about how tax might be used to help fill the gap over the coming years.

Michael Marra: I want to ask about a couple of particulars. First, on the 3 per cent target for efficiencies in NHS boards, do you have clarity on whether those efficiencies would accumulate to the health boards or whether they would result in a reduction in the deficit?

Stephen Boyd: We do not.

Michael Marra: Do you have any clarity on the status of the £1.4 billion of additional spending committed to by the Scottish National Party in its election manifesto and whether it will add to the scale of the deficit?

Stephen Boyd: I have nothing to add to Dr Sousa's response to the same question. I thought that he answered it very well.

Michael Marra: So, you do not know.

Do you agree with the IFS's recommendation that, in the absence of an MTFS this year, this committee might pursue an updated FSDP? Would that be a useful tool?

Stephen Boyd: That seems absolutely reasonable.

Michael Marra: Okay. That is appreciated.

Mr Boyd, you also said in your submission that

"There is a danger that overly optimistic assumptions on the potential fiscal benefits of reform measures might push back a more clear eyed"

view of what might need to happen.

I ask all three of you to reflect on some of the measures set out in last week's programme for government. Thinking of health boards in the first instance, do you have any clarity as to whether those measures will contribute to savings to meet the deficit, or are they actually all about changing the delivery mechanism and improving outcomes?

Stephen Boyd: My understanding from a reading of the documents is that they are a bit of both. My concern would be that, on the fiscal side of things, realising those savings over the course of this parliamentary session will be tremendously challenging. Indeed, if you are going to do change well and effectively, you are, in the shorter term, probably looking at additional spending. Therefore, it is unlikely that, over the course of this parliamentary session, those measures will make a significant contribution to filling the gap that was discussed at length by the previous panel.

Alison Payne (Enlighten): There is a lack of clarity about how those measures might work. With regard to the reforms to the structure of the health boards and the proposal for two mainland boards, there has been no great discussion about what will happen to the delivery of primary and community care, because, at the same time, we are also reviewing local authority boundaries. It is not as though we can say, "Well, okay, primary care is going to be devolved down to local authorities", because we are going to be changing our local authorities, too. There is a lack of clarity about how things are going to be organised.

My concern is the lack of joined-up thinking with regard to the health board and local government structures. Those things need to be looked at together, because we are looking—and properly so—at where responsibilities lie and how powers and spending should be organised in a strategic way. We cannot march ahead with the health boards and then tack on local authorities later. The two things have to be looked at in conjunction.

As for savings, I do not see how we can possibly have clarity on that issue, because we do not know what structures we are going to have.

Michael Marra: Are you worried about up-front costs, which Stephen Boyd mentioned, because we have a short period to address the fiscal deficit and find a path to balance?

11:15

Alison Payne: Definitely. You gave the example of police centralisation in the earlier evidence session. Generally speaking, when a service is rationalised or centralised—regardless of whether that is a good thing—there are up-front costs, with savings coming considerably later.

The FSDP talked about the need to review every spending line, but I do not think that there was any evidence of that last week. For example, there will be additional spending on breakfast clubs, which sound like a great idea in principle, but, when we start unpicking the policy, we see that there could be capital costs. Where on earth are we putting 500 kids who start school at different times? Where is the room? Where are the teachers and staff? Will there be capital costs associated with that? That additional spending is not clear, so how does that new commitment sit alongside the commitment to review every spending plan and to consider impacts and outputs? We are still focused on inputs rather than outcomes.

Michael Marra: Professor Gallagher, does the programme for government set us on a path to sustainability? Is there any clarity on that?

Professor Jim Gallagher (Royal Society of Edinburgh): On the extent to which the programme for government will enable public sector reform, it should, in principle, be able to contribute to the necessary budget savings, although those are very large and the timescales are problematic.

However, if the public sector reform programme is to have an impact on spending, it needs to be much more concrete than it currently is. The RSE gave evidence to the Public Service Reform Committee on that point. These issues are deeply connected. If public sector reform is to make a contribution, even over a rather longer period, there is the need for a series of specific proposals that will save money, rather than a series of broad acceptable principles that do not contain any concrete reforms.

Over the past 10 years or so, the only substantial reform of this kind has been in relation to the police, as Alison Payne mentioned. That has produced budget reductions—not because of the reform but because the number of police officers has been reduced.

That takes us to the question of merging health boards. There is nothing magic about the present number of health boards—that number is perhaps an accident of history—so there might well be nothing wrong with merging health boards, but it is reasonable to ask whether two is the right number.

It would be a mistake to assume that we would get substantial savings from cutting the top hamper of organisations or merging them. Most of the expenditure pressure comes not from the high heid yins but from the people who do the work—the doctors, the nurses and the support staff—simply because of the volume of them. Some savings could be made by having fewer chief executives and directors of finance, but, arithmetically, the savings would not come to all that much, even though those people are relatively well paid.

The challenges for the budget round in respect of public sector reform relate to the lack of concrete changes and the timetable by which such changes, if there were any, would be made. The public sector reform strategy is full of additional documents, propositions, plans, pillars, foundations, beliefs and principles, but it does not contain a single concrete reform programme.

Michael Marra: You mentioned cutting the top tier of management. I imagine that, if we moved from 14 chief executives to two, those 12 chief executives would have to be paid off, and any organisation would have to deal with those costs over a period of time. Therefore, initial up-front investment would be needed to allow the change to be made. Is that the case?

Professor Gallagher: That is undoubtedly correct.

The Deputy Convener: You said that big savings need to be achieved. I do not want to belittle the sums, because we are talking about large sums, but, in reality, only a small percentage of the Scottish budget needs to be saved. I am not saying that there will not be a challenge; I am just talking about the percentage of the budget.

Professor Gallagher: You are right that we are not talking about 10 per cent of the Scottish budget but about 1, 2 or 3 per cent. The medium-term financial strategy, which the RSE has welcomed as a first step in that direction, identifies some potential savings, and those amount to a few per cent of the budget.

It is not certain that all spending pressures have been taken into account in the medium-term financial strategy. As the earlier panel pointed out, substantial components of the Scottish budget are now demand-determined rather than chosen by ministers. The mechanisms for managing that demand, particularly in relation to social security, are very limited.

There is an upside risk to spending, and the capacity to make the savings over the period that we are talking about is, I am afraid, limited. The Scottish Government’s ability to deliver those savings does not seem to be readily available in the short term. The result, I fear, is that straightforward salami-slicing cuts might have to be made in order to achieve savings of, say, 1.5 or 2 per cent, which, in other organisations, would certainly be achievable.

The Deputy Convener: Stephen Boyd, your organisation has said that, in the spending review plans, we need to shift practice more towards prevention and reform. Preventative spending is the holy grail, but how do you make that shift in the short term, and how do you measure the benefits of, say, additional up-front investment in preventative spending?

Quite often, organisations will say that if you spend £5 here, you will save £10 in the long run, but you are almost trying to prove a counterfactual at the outset with that investment. How do we reshape that while we are trying to deliver public sector reform, and how do we make that shift in a meaningful way?

Stephen Boyd: It is worth commenting on the fact that the Christie commission proposals achieved a degree of consensus in Scottish civic society and political circles that is highly unusual for Scotland. It presented a real opportunity 15 years ago to make a decisive shift towards preventative spending. The fact that that has not really happened emphasises the challenges that are inherent in this agenda.

The key challenge is to do this well. We are looking at additional spending in the short term, which is why decisions have been postponed and postponed again over the past 15 years or so. The Scottish Government’s recent introduction of the preventative budgeting tool is interesting. I have not found time to properly interrogate that issue with various stakeholders, but we will look to do that over the coming year or so.

The preventative budgeting tool signals a degree of seriousness that perhaps was not there in the past. It is the right thing to do, but will it have a tangible impact on addressing the fiscal gap by the end of this decade? Probably not.

Alison Payne: We need to invest in prevention, and there must be that shift, but a shift implies that we need to stop doing something else. That is the one thing that we have not really had a conversation about. Efficiencies are not enough. If we want to shift investment towards prevention, what will we stop doing? Too often, that conversation is being ducked.

Professor Gallagher: The prevention question is very important. The first thing to consider is that everybody agreed with the Christie commission 13 years ago. They all said, “This is a great idea. We believe in this.” We have to ask ourselves why, in substance, it has not happened, because it has not.

There are potentially two reasons for that. First, take, for example, the prevention tool that Stephen Boyd mentioned. Prevention is not an abstract concept. If you want to prevent something, you have to know what it is. What is the bad thing that you want to stop that is costing lots of money, and how will you prevent it? The prevention tool has none of those things. It is a bit like the public sector reform strategy: it is insufficiently concrete.

The second reason is that you have to drive prevention because, as Alison Payne said, it requires you to make some cuts today to find the money to invest for uncertain savings in the future. If the Government is unwilling to be bold in wanting to do that, in having the drive to put it into practice, and in knowing where to put the money, we will not get any prevention, and that has been the experience for 13 years.

The Deputy Convener: On that shift from potentially stopping doing something to put more money into preventive spend, I am hoping that my colleague Liam Kerr is going to help me, because he has sent me a note saying that he wants to come in on two ways to save money.

Liam Kerr: We have talked about services, the size of the workforce and cuts. The previous UK Government had a public sector productivity programme which put, I think, £800 million into delivering £1.8 billion of savings by 2029, especially by using things such as technology and artificial intelligence. Is there any evidence of the Scottish Government doing any similar thinking around productivity, especially in relation to technology?

Professor Gallagher: Public sector productivity, unlike productivity in the private sector, is quite hard to measure. In the private sector, you have got money in and money out, and you can see when you are getting more money in for less money out, or more money out for less money in. In the public sector, your outputs are not marketised—you cannot put a price on them—so productivity is hard to measure.

South of the border, the ONS has made an attempt at measuring productivity. I would not put too much authority in it, but it suggests that, in England and Wales at least, there has been some improvement in public sector productivity, although the mechanism by which that has been achieved is not clear. No detailed measurements have been made in Scotland, although the assumption of the Scottish Fiscal Commission—I think that it was the Scottish Fiscal Commission—was that, looking back, public sector productivity in Scotland had not improved. There was no data on that, however.

You might well be right about the use of AI. If one looks at the public sector reform strategy, one place where it is seeking improvements is in so-called back-office functions. The RSE’s view is that it is unhelpful to make a distinction between “back-office” and “front-office” functions. Nevertheless, some of the processes that one thinks of as back-office processes might well benefit from the use of AI.

Alison Payne: I will not draw on the public sector particularly, but there is plenty of evidence and learning that could be had from the third sector and from people who are working in communities. Organisations such as the Wise Group, Chest Heart & Stroke Scotland and others that are delivering prevention while working on tight budgets and having to constantly manage themselves have been able to show productivity and how they can develop outcomes.

On the technology side, there is lots of potential from AI, but there are some basics that we need to get right first, such as improving our health data and data sharing. If you look at the development of the health app in England, compared with the fact that we do not share health data between hospitals and general practitioners here, we are still trying to play catch-up. There is massive potential there that we have been talking about for years. If an occupational therapist or a physical therapist works for a local authority, they have access to different patient records than if they work for the health board. People have been trying to address those issues for years, but they have always been stuck in the “too difficult” pile. There is so much work that we should be doing around data sharing.

Stephen Boyd: First, Professor Gallagher is absolutely right that measuring productivity in the public sector is incredibly difficult. The ONS has just been through an extensive review. That came 20 years after the Atkinson review, which was a review of public sector productivity, and the exercises were almost exactly the same. That points towards the intrinsic difficulties here. Measuring productivity in some private sector services can be difficult as well, but the difficulty here is massively compounded by the lack of market prices being attached to outputs.

Secondly, when it comes to the public sector, we are talking about the delivery of intrinsically labour-intensive personal services. The rate of productivity growth in those services will always lag the economy as a whole—that is probably one of the best-evidenced areas in all economics. We should be modest in our expectations about what we can achieve through productivity improvements.

11:30

Thirdly, we need to tread carefully with technology. The issue is whether we adjust for quality in our measurement of productivity. For example, health services have been utterly transformed by technology over the longer term, which has resulted in massively improved outcomes, but the technology has added to costs because they tend to complement rather than be a substitute for labour.

In manufacturing, new technology tends to displace labour, which leads to consistent and large productivity rises, but that does not happen in public services, where there are instead better outcomes. Depending on how we adjust for quality, there can be increases in productivity in public services, but non-quality-adjusted measures are what matter when it comes to costs. Quality-adjusted measures might go up but non-quality-adjusted spending will continue to rise year on year.

William Baumol, the economist who led the agenda on this issue, noted that it is all very well to say to a hospital administrator that their quality-adjusted productivity is going up year on year, but that administrator will say, “Well, so are my costs.” We need to tread carefully when we talk about productivity in the public sector.

Liam Kerr: I understand. I have a related question. Between 2022 and 2024, UK Government departments saved about £300 million in cost efficiencies for running properties. It did co-location, set up Government hubs and that sort of thing. Is there any evidence that the Scottish Government is looking at the same sorts of things to mitigate reductions in front-line services?

Professor Gallagher: Yes, some buildings have been disposed of, as I think that the Minister for Public Finance described—that was perhaps even in the previous parliamentary session. I believe that the Scottish Government is planning to dispose of some more buildings, which is entirely sensible.

Liam Kerr: I am grateful.

Michael Marra: I will take a quick step backwards. The deputy convener identified the scale of the adjustments that will be necessary. Stephen Boyd, you made some comments in your submission about where those will fall. In essence, because there are parts of the budget that are protected, such as health spending growth and the number of front-line workers, you set out that certain sectors could have a staffing reduction of 13 per cent by 2029-30. Will you expand a bit on the differential impact that those cuts could have?

Stephen Boyd: It is all there in the spending review. Throughout the next three years, there will be real-terms spending cuts in education, skills and local government—I am afraid that I do not have all the details to hand. Even the real-terms spending increases in health will, by the Scottish Government’s own numbers, be insufficient to meet current demand.

There are also specific targets. We focus quite tightly on the target to reduce the head count by 0.5 per cent per annum. The Scottish Government has said that that target will be met by losing jobs in back-office functions, although we do not accept that the delineation between front-line and back-office jobs in the public sector is valid or helpful. However, if we assume that certain areas of front-line delivery will be protected and that health and social care employment will continue to rise roughly in line with demand, then there will need to be significant cuts in areas that the Scottish Government might describe as “back office”, probably amounting to the loss of 20,000 jobs by the end of the decade.

The target is all well and good, but we think that it is unlikely to be achieved without significant costs to the quality of public services. However, if that is the target, then the Government needs to set out how it will be achieved, how it will be affected by demand, how it will affect the quality of services, and so on. That has just not happened thus far.

Michael Marra: Thank you.

Pauline Stafford: Regarding risks to the Scottish spending review, one of the IPPR submission points was about

“climate change adaptation, mitigation and damage repair measures.”

I am conscious that we are all here after a volatile summer of responding to those emerging impacts and that, in the future, they will probably will not emerge in a smooth or predictable way. Are there any Scotland-specific climate risks that you think will emerge in the next decade, and does the fiscal framework give us enough resilience to be able to respond to the scale of those potential shocks?

Stephen Boyd: Yes, it was really brought home to me in the summer. I was walking to the green loch in the Cairngorms the day before the wildfire started, so it all seemed very real. I am not sure about Scotland-specific risks, so I would have to give that a bit of thought, but the experience throughout Europe this summer has shown us that these risks are very real. Wildfire is an obvious risk that Scotland seems quite exposed to.

The broader point is about the capital spending challenge, which I think Professor Bell touched on in the earlier evidence session. The approach is certainly about climate change mitigation and adaptation, but we also want to build the supply chains that relate to the build-out of renewables and so on, which will undoubtedly require public investment. Some additional flexibility on that would be very welcome, to allow the Scottish Government to invest in those areas, particularly where that will leverage in private investment.

Professor Gallagher: I am pretty sure that Stephen Boyd is right to say that the Scotland-specific risks are relatively small, compared to the big risks that you referred to. In particular, you asked whether the fiscal framework will cope with that. To the extent that the UK Government deals with these UK risks, that will feed through in the fiscal framework and the Barnett formula.

Michael Marra: On bonds, the RSE submission said:

"The RSE feels the Scottish Government's plan for the purpose and mechanisms for bonds is unclear".

The Government's approach to that seems to be accelerating—we are hearing announcements—so I am interested in why you feel that there is a lack of clarity on the key issues of purpose and mechanism.

Professor Gallagher: To put that into context, bonds are not a way of spending; they are a way of financing. They do not produce any more capital spend. That is all constrained within the capital spending totals, so the question is whether bonds can effectively be used as a substitute—this was discussed in the earlier evidence session—for borrowing from the national loans fund, which is where the Scottish Government borrows all its money from at the moment.

The lack of clarity lies in the nature of the process. The Scottish Government has spent a reasonable amount of money trying to ascertain the potential demand in the City of London, which is where one finds the market. However, it is not clear how turning that financing into bonds that are value for money will be done. The underlying reality is that we are not aware of any subnational Government that pays less than the sovereign Government for the issue of bonds. The reasons for that are obvious. First, the subnational Government has a smaller revenue base and is dependent on the national Government for some of that. That is true worldwide; it is not just a Scottish story or a UK story. Secondly, there is always a degree of uncertainty, as we see in the United States, about the extent to which a national Government would stand behind bonds issued by a subnational Government. As far as one can tell, those uncertainties have not been answered in the Scottish Government's proposals on the subject.

Stephen Boyd: I tend to agree with most of that, and I agreed with Dr Sousa's comments in the earlier evidence session. It is not clear where the view that bonds would be a cheaper way of borrowing has come from. It is widely assumed that it will be more expensive, although that is a slightly unpopular point to make.

I do not think that it is unhelpful that the Scottish Government is engaging in a really comprehensive way with the financial sector and markets, in a way that it has not done before, and building that capacity is potentially to the long-term benefit. If that comes at the cost of more expensive borrowing, at a time of very tightly constrained public finances, I can understand that questions will be asked, but the work that has been done up to now is likely to stand the Scottish Government in good stead in the longer term with regard to capacity building.

Michael Marra: I accept the point about the trade-offs and the potential. My concern is that, in the budget process towards the end of this year, we might be told that part of the capital shortfall that the committee is concerned about will be addressed by a bond at some point, with the assumption that that will all be fine, when those trade-offs have not been set out to the Parliament or to the committee in a policy statement. It sounds as though you have not seen that detail. I see shaking heads.

Professor Gallagher: It is not possible to address a capital shortfall—a gap between the capital budget and the aspirations for capital spending—through additional borrowing. All our capital funding is funded either directly by the Government or within the existing borrowing limits through the national loans fund. A bond would just be a substitute for borrowing from the national loans fund; it would give no additional spending power.

Michael Marra: That is a very useful clarification. There is still the risk that, in the budget process towards the end of this year, that option will be presented without the details on the policy trade-offs being set out to the Parliament. Should the committee pursue a more detailed account from the Government of its perception of the costs, policy trade-offs and—I am sure that it would want to include this—opportunities in relation to bonds?

Professor Gallagher: If the Scottish Government were to propose the issuing of bonds, it would have to make provision in its budget for the additional costs—the spread, in the jargon, as I mentioned earlier—including the administrative costs, which would be substantial.

As was explained in the previous evidence session, one does not simply pick a bond off a shelf. One has to construct it oneself and decide its terms, its duration—how many years one is borrowing for—to whom it should be marketed and who should underwrite it. At a price, it is possible to get a bank to say, “If nobody else buys it, we will buy it off you.” That is underwriting. The Government would also have to decide how the yield would be assessed in advance—in other words, what the Government thought it would get for it. The moment of truth would come when the Government offered the bond for sale. If somebody offered to buy it at a much higher price than the Government thought, that would be the point at which it would be in trouble.

Michael Marra: Last week, the Scottish Fiscal Commission told the committee what it perceived its likely role would be in that process. I found some of that evidence slightly concerning. The commission would have a role in making projections on the Government’s broad budgetary position on income and expenditure, but it would also have to adopt a position of neutrality, given that it would not want to comment on a market-sensitive issue such as the likely issuing of a bond. Is the infrastructure relating to the budgetary pressures resulting from the issuing of a bond accounted for in Scotland’s current fiscal apparatus?

Professor Gallagher: If you look at the spending review, I do not think that you will see any funds set aside for the administration costs of bonds, which could well run to millions of pounds—potentially tens of millions of pounds. It is not a criticism of the Scottish Government to say that, at the moment, it does not have the technical capability required, so it would have to buy that in, as it has done for its exploratory work.

Michael Marra: I am happy to hear from the other witnesses, too, but where in the apparatus would we find an objective assessment of the fiscal impact of meeting the costs of an unissued bond, given that we have a constrained fiscal settlement? By that, in technical terms, I mean that the Scottish Government and other devolved institutions have a constrained set of options, whereas the UK Government, as a sovereign issuer of debt, has other options and broader borrowing powers. Who is going to tell us how much this could cost?

11:45

Professor Gallagher: There are two issues. First, on who would make the estimates, I imagine that it would be a combination of Scottish Government officials and whatever advisers had been brought in for the bond launch, if there was one.

Secondly, ultimately, whether that is value for money would be a matter for the accountable officer to determine. My understanding, although this is not gospel, is that that would be the permanent secretary to the Scottish Office. If he took the view that the issuance of bonds was not good value for money compared with alternatives, it would be for him to seek a direction from the Scottish ministers to proceed nevertheless, if that is what they wanted to do.

Michael Marra: Sorry, but did you say the permanent secretary to the Scottish Office?

Professor Gallagher: I meant to say Scottish Government. It would also be for the Scottish Parliament. Thank you. I am showing my age, Mr Marra.

Michael Marra: I am sorry. That is a useful clarification. Is there any other input on that? Stephen Boyd?

Stephen Boyd: I do not think that I have anything to add, but I think—

The Deputy Convener: We will just move on and let other colleagues in, as the question has triggered quite a few supplementaries.

Michael Marra: I thought that he was eager to come in. Okay. No problem, convener. Thank you.

The Deputy Convener: I suspect that the supplementaries will provide further answers.

Kim Schmulian: In the past, we have often relied on capital projects to produce economic growth. Given that we have had scant economic growth in recent times and that the level of our capital debt is quite high, are the Scottish Government’s plans on capital spending slightly ambitious?

Alison Payne: They are not clear, and there is not enough detail. Let us consider the programme for government and its knock-on effect on capital expenditure. You mentioned breakfast clubs. That proposal could quite easily necessitate additional capital expenditure, as could some of the other proposals. If we are looking to properly restructure our health boards so that we end up with more centres of excellence, are we looking at additional hospital programmes as part of that? If we are centralising services, it would make sense to build and properly develop centres of excellence.

I am not sure from last week’s programme for government what additional capital expenditure would arise—what would be the knock-on effect—of the policies that have been announced. There are still an awful lot of questions that we do not have answers to, and things do not tie up with what was set out in the medium-term financial strategy and the fiscal sustainability delivery plan. There is a lack of clarity and a lack of properly allocated funding regarding what we are doing and how we are paying for these things. Too many questions remain.

Kim Schmulian: It comes back to the general feeling that we are walking in the dark with a torch, often, in terms of—

Alison Payne: We know that we are walking in the dark with a torch. The most frustrating thing is that we know that these problems are there. We have spoken about Christie. We know what we need to do. Whether we learn from others who are operating in Scotland and delivering the prevention programmes that we talk about, we know what we need to do. The problem is that we seem to have had a long-term delivery problem. We do not know how to get from where we are to where we want to be, or how to make the painful political choices that we have to make along the way to get there.

Council tax was mentioned earlier. The problem is that there will be winners and losers. In order to make the shift and the changes that we require, some people will lose out and they will not like some of the policy prescriptions. We have been too afraid of having those hard conversations.

Kim Schmulian: We do not have a good track record of delivering capital projects. They are over time and over budget. That seems to be a continuous story.

Professor Gallagher: To be fair, some capital projects have been delivered on time. An example is the new Forth road bridge, the third Forth crossing, as it was known at the time. However, others have been quite disastrous. The ferries story stands as an example.

To return to your original question about whether capital investment improves the economy, it depends as much on what the capital investment is as on how much of it there is. In the so-called fiscal gap, there is a chunk that is supposedly a gap in capital expenditure. That is a gap between the Scottish Government's aspirations and its budget. The question is how you spend your budget.

Capital can do two things for the economy. One is to make the public sector more efficient. Generally speaking, it increases costs, because you get a nice new hospital—or maybe not a nice new hospital—for example. The second one is investment in infrastructure to improve economic growth. That is critical for the economy and can probably be best managed at the regional, rather than the national, level, which takes us to the allocation of capital spend to local government or regional partnerships.

Stephen Boyd: Professor Gallagher has set out nicely the economic case for capital spending. Looking at our particular challenges in Scotland, we see that there are obvious areas that require investment as soon as possible. Housing is a key area. There are many contributing factors to our relatively low rate of productivity growth, but housing constraint is increasingly a major factor. Yes, there is a social need for housing, but there is also an economic imperative.

To refer back to the various climate change investments that were mentioned earlier, and how we build supply chains in the renewable energy sector, some public investment in port and transport infrastructure would definitely help to leverage in private sector investment.

It is also worth stressing, with regard to our conversation today about the Scottish Government's budget over the current session of Parliament, that the idea that we are going to identify bits and pieces of infrastructure, deliver them over the course of the session and then see the fruits in terms of higher economic growth is not particularly credible. It is a much longer-term issue.

The Deputy Convener: A couple of other colleagues want to come in on capital and growth. First, however, with regard to project delivery, the civil engineer in me feels obliged to point out the M74, the M80 and the M8 upgrades. It is also worth noting that rail electrification in Scotland is 50 per cent cheaper per kilometre in comparison with the cost in rest of the UK, so there is some good news on capital delivery projects.

Liam Kerr: To follow on from Michael Marra's questions on bonds, the Scottish Government is also proposing a mutual investment model. Some might say that it looks rather like a private finance initiative or public-private partnership model, except that the public sector gets a share of the returns and holds an equity stake in the project.

I turn to Stephen Boyd. The IPPR has said that that model could lead to higher long-term costs. Can you explain that? Can it be designed in such a way that it provides value for money?

Stephen Boyd: We are speculating there, because we have not seen sufficient detail to make a proper assessment of that. In the same way that the PFI led to higher costs that were unforeseen at the start by not delivering the quality of service that it was intended to deliver, we can see similar outcomes emerging from this model. However, I would be reticent about commenting on it in any detail until I see much more detailed plans.

Professor Gallagher: This is an important area. In a time of constrained capital spending, harnessing private investment to provide assets may well be a good thing. The challenge is structuring the transaction in such a way that everybody benefits. Private capital has to be rewarded. There is an interest charge, and it will be bigger than the interest charge that you would get by borrowing the money, if you could, from the national loans fund, so the structure of the project has to deliver better outcomes or lower costs in the service concerned.

To put it simply, buying things on hire purchase is more expensive than just buying them. I am afraid that we have been a bit guilty of that in the provision of assets. You get the private sector to build a school, say, and you pay for it over 25 years. You get some benefits, because the private sector may well build it more cheaply and might control the costs well over 25 years. However, the main thing that is going on in the school is the teaching, and it has no real effect on that.

It is, however, possible to imagine ways of structuring deals that are a win-win, and it is certainly a good idea for the Scottish Government to be thinking about that model. Housing might well be an example; the Scottish National Investment Bank is trying to attract private investment into housing. I am not sure that it has got it right yet, but at least it is trying. There is scope for private investment to be drawn into public projects and for the benefits to be shared between the investor and the public.

Alison Payne: I think that there is potential around social impact investing. There has been a few pilots of that approach, in which there is a private sector investor and a third sector organisation as the delivery partner. However, it has fallen down when it comes to getting the public sector on board.

It is important to try different things. They might not always work, but it is a matter of trying things on a small scale. The Growth Partnership has done quite a lot of work here, and Gordon Brown looked into social impact investing during his time in office. There is potential for experimenting, and that would be a way of bringing in more expertise on delivery from the third sector.

I will touch on one other thing. Sometimes we are not great at the long-term look when it comes to capital projects. You mentioned rail electrification. For example, we built the Borders railway, and it has been a success, but we did it in the short term. We built bridges that were not suitable for a dual track. If that line is to expand, how do we think about that for the long term? We might want to create a dual track in future, but there are bridges that are set in such a way that we cannot expand the line.

When we are doing such projects, how do we think to the long term, not to the short term or to the immediacy of just delivering something? If we thought about the long term, that might involve building a bridge so that it goes over the space, even if we cannot afford to dual track the line at the moment. It is about having that foresight and thinking ahead. We have not been great at dealing with the longer-term implications of some of the decisions that we make.

The Deputy Convener: The funding envelope was different even at the time when the Borders railway was built. Is that not potentially a function of constrained capital borrowing and very tight capital limits? You can have aspirations to build X but, after looking at your spending envelope, you might conclude that you cannot do that. That is where you make some savings. I take the point about the dual track and the bridges, but there are funding envelope pressures that need to be managed as well.

Alison Payne: We tend to focus on the short term. I can totally understand those pressures, but a cost will just build up in the longer term. Expanding the Borders railway, which has ended up being so much more successful than we thought it would be, becomes so much more expensive because of needing all the additional infrastructure. If we can afford to pay more up front in the shorter term, the longer-term potential for developing things further down the line is greater.

The Deputy Convener: Presumably that means getting the business case model right. In the case of the Borders railway, the passenger numbers were greater than was initially predicted.

Alison Payne: Yes.

Professor Gallagher: As it happens, I was working in the Scottish Government in those days. At the time, the business case for the Borders railway was marginal. It turns out that the numbers have been so much better than expected—business cases are not always right—but it might well have pushed the Borders railway into an unacceptable business case if we had future proofed it. I suspect that it was not so much an issue of capital constraint as to do with the assessment of the business case at the time. That is a long time ago now, of course.

Pauline Stafford: I have a couple of questions for Professor Gallagher that are in the same vein. In relation to capital spend and helping economic growth, the Royal Society said in its submission that, for public finance, we should be considering

"joint funding to de-risk … developments"

for innovative businesses, start-ups and scale-ups. I put this question to the whole panel. What is your take on the role of public finance in shaping the direction of growth and leveraging in private money to support some of those businesses? You touched on the Scottish National Investment Bank and spoke about how we could look to use bonds for social impact investing.

Professor Gallagher: I think that the social impact bond question is slightly different, so I will come back to that separately.

It is undoubtedly the case, in a way that did not apply 100 years ago, that the public sector and the Government have a role in promoting economic development. We can slice it in different ways. The first and most important thing to note is all the supporting infrastructure that makes an economy work: everything from the court service that enforces contracts to the education service that ensures that people are able to work, as well as concrete projects—the bits of physical infrastructure that enable people to get to their work and allow businesses to send their products in and out.

12:00

You have to integrate all these things, and one of the relatively recent successes of both the Scottish and UK Governments in that area is the city deal partnerships, which are focused on doing precisely that, and—to come to where you began your question—public bodies are investing, alongside private sector bodies, in enterprises of one sort or another. It must be both, because, typically, you are taking a bit of a punt, because you are not sure that the enterprise is going to work. However, it also has to be investable for the private sector; otherwise, you are going to throw money down the drain.

That is the role of the various economic development agencies in the Scottish Government, on which we spend about £2 billion a year—I say that from memory, so the figure might be wrong—so we ought to be getting good results. I guess that we are not, so far. Finding a way to mix the private sector with the public sector is something that we have not yet quite got right. There are arguments about where the private sector falls short. It is traditionally said that private equity managers cannot go beyond a day's travel to visit the businesses that they are investing in, and part of the Government's job is to make it a bit more attractive to do that.

The challenge in all that is integrating the stuff, and the large number of public bodies that are involved in economic development is a challenge in that regard. Audit Scotland has pointed out that there is rather too crowded a landscape in public sector support for enterprises and it needs a bit of simplification—a one-stop-shop approach, if you like. We have Scottish Enterprise, South of Scotland Enterprise, Highlands and Islands Enterprise, VisitScotland, the Scottish National Investment Bank, and a list of local authorities with these players and some that I have forgotten—there is Skills Development Scotland, for example. There are too many players on the pitch for the game to work, but the principle is correct.

Alison Payne: I want to mention the local government element of that in relation to public finance and how it supports growth. We cannot do it all from the centre. You will have seen the recent news story about job losses in Inverclyde. If Inverclyde is swept up with Glasgow and the greater Glasgow area, the impact on the community in that area is lost, which is why it is so important that local authorities are a key delivery partner in a great deal of what happens in this regard and in how we address the different needs and the different circumstances that impact a place, whether that is Inverclyde or Inverness.

Different priorities need to be addressed, and there are infrastructure differences. For example, there is the £2 bus fare cap, which has been spoken about a lot. In Edinburgh we have a bus service that functions excellently and has undoubtedly contributed to economic growth, but in other parts of the country kids cannot get to school on time on the bus. We cannot have too much of a once-for-Scotland approach, because we must acknowledge the different needs and circumstances in Scotland and empower the different communities and regions. Where we can pull things together and drive things in a more efficient way, we should, but it is really important that everything is not driven from the centre.

Stephen Boyd: Yes, and the business growth ecosystem in Scotland is just not working very well. Our track record over the whole period of devolution has been particularly worrying. For example, I remember sitting in this room 20 years ago talking about the opportunities in renewables. Have we in Scotland developed a domestically owned firm of any real scale in that sector that is now plying its trade across the world? We have not really.

Recently, I carried out an exercise looking at the 10 largest domestically owned firms by market capitalisation across a range of European countries, and Scotland performs really worryingly badly—for example, compared with Denmark, whose combined market cap is about $700 billion. Novo Nordisk accounts for about half of that figure, but other really big domestically owned players contribute. Most are trust owned, which means that all the decisions have been made within the country.

In contrast, let us consider Scotland's 10 largest domestically owned firms. There is SSE, which has a market cap of £25 billion, although you could argue about the extent to which it is domestically owned. Then we go down to Weir, which is worth only £8.5 billion.

The business landscape in Scotland is worrying. Who is to blame for that? We have spent 20 years arguing about that question. At times, it has been argued that there is an overfocus on enterprise networks. I would not argue that they are working perfectly, but the private side of the ecosystem is certainly also not working well in nurturing Scottish firms.

I am also sceptical about the crowded landscape argument. It is not difficult for a business that is looking for support from Scotland's public sector to find it. I have spoken to many firms over the years that have leaned on the enterprise networks and Skills Development Scotland for support at important points in their journeys, and they have not found that support hard to come by. Again, I am not saying that the system is perfect, but we need to consider both the public and the private sides.

We also need to raise the issue of profile in Scotland. It should concern us all if we are not managing to grow domestically owned firms at any scale, and I do not think that we are managing to do that, although people can always point to outliers. The problem requires a holistic view of what is and is not working.

Pauline Stafford: The other part of my question is more specific. You mentioned that this is outwith our control, but improving grid connectivity and capacity will require investment. To what extent is inadequate grid capacity now becoming a constraint on economic growth and providing security to private investment in Scotland?

Professor Gallagher: I am afraid that we have not looked at that in the RSE.

Stephen Boyd: My understanding is that the grid is a constraint. There are a range of issues that relate to how we can effectively invest in the grid and whether that is best done on a UK-wide or a Scottish basis. It is a complex issue. We are again confronting the challenges that are posed by decades of underinvestment in the system.

The Deputy Convener: Stephen Boyd, you spoke about renewable energy, and there is an ongoing debate about whether we should maximise those opportunities. You said that you feel that there has not been enough supply chain development. For so long, when it came to auctions on contracts for difference, it was a case of the lowest price winning. Therefore, it became much harder to invest in start-ups or to get companies up and running, because they were competing with established foreign investment or places where labour is cheaper—China cornered a lot of the market—and so it became much harder to compete and build up a supply chain. Is that one of the factors that has limited the growth of a manufacturing supply chain for renewable energy?

Stephen Boyd: It may well be, but the issues are much broader and deeper and extend much further back in time. As I said, I remember sitting in this very room 20 years ago, discussing renewables. There were a bunch of companies at that time that were at the global frontier in their own particular sectors, such as Pelamis Wave Power and Wavegen up in Inverness. There might be an issue with the viability of wave energy technology at a commercial scale, but we can also consider tidal and onshore and offshore wind energy. Why did the extent of the opportunity in Scotland, which we have been discussing for a long time, not lead us to develop our own domestically owned companies of scale in that sector?

There is a broader issue with the business development ecosystem. Yes, there have been failures on the public side, but there have also been significant failures on the private side. That is a UK issue as much as a Scottish one, so what is it about the UK system that does not allow us to develop companies of scale in the way that other countries seem to be able to do quite regularly? I would not pretend to have an answer to that question—certainly not one that I could articulate quickly—but I would like there to be much more public debate about this issue over the coming months and years.

The Deputy Convener: I agree about having greater public debate. I actually now want to have a debate with you about public energy choices, but I will leave it at that.

I am conscious that I have not yet brought you in, Liam McArthur.

Liam McArthur: I want to go back to a point that Ms Payne made earlier, and offer a confession similar to the one that Professor Gallagher made. I was in the Scottish Government at the time when the first business cases for the Borders railway were being put forward. To put it bluntly, "marginal" is probably the most charitable description of how officials were suggesting that those first business cases looked. I think that the problem at the time was that those business cases were being looked at and analysed as though they were transport projects in the central belt, when there was actually a political decision about infrastructure investment in areas outwith the central belt.

To link back to the points that were discussed earlier about concerns raised with the committee, in written submissions from a range of witnesses, about efficiency savings leading to service reductions, that seems to be a concern across the piece. I would argue that there is probably a greater level of concern in some of the rural and island areas about a disproportionate impact from those service reductions as part of the efficiency savings process.

As we take the reform process forward, alongside all the other things that we need to see the Government, and us collectively, achieving as part of that, what weighting do you suggest we should attach to ensuring that there is an equitable approach so that some parts of the country are not paying a heavier toll than others for driving these efficiencies?

Alison Payne: I suggest that you need to start the whole process from the bottom up. If you do it from the top down, you are going to end up having huge problems.

We recently shared an article from a woman in Tongue talking about the problems in social care, and issues with palliative care when people are dying in a remote area. There are community organisations that could deliver those services, but the health board has an inability to adapt its one-size-fits-all approach—it simply says, "Oh well, we can't do things differently." We have to be able to deliver services in different ways in different parts of the country, and if we start from the top and go down that will be very difficult.

If we look at what is already working in many of our communities, we can see how we empower those who are already delivering public service reform. Why do we need to constantly reinvent the wheel and have everything done from within Government?

If you work with the communities in those places that you have identified, where there is a potential danger of people feeling that they have been left out and are suffering disproportionately, you will see that, in many of those communities, there are groups already doing that work, and making up for the existing shortfall.

How do you empower those groups? That would be my starting point: you should look at what is actually happening and who is working on that, and bring them in as partners in delivering public sector reform.

Too often, the third sector is an adjunct that is brought in at the last minute. It needs to be a key partner, and we need to be willing to deliver services in different ways in different places. We need to try different things as well. There is sometimes a danger of saying that if something has worked in one area, it will work all over Scotland, but it does not always work like that. It is a case of saying that what is right for one area is great—let that work there, and let us see how we can adapt and learn from it.

Working with our communities has to be the starting point. If we are going to end up with two health boards or fewer local authorities, there has to be more going on down at a community level.

Liam McArthur: During the reform process, individuals and teams—for understandable and entirely human reasons—may be desperately looking to justify the roles that they play. They may try to adapt those roles somehow, but in a sense they will be circling the wagons. Is there a risk, therefore, that the sort of discussion that you are talking about, and designing in third sector involvement from the outset, becomes more difficult because there is an element of people defending their patch, so to speak?

Alison Payne: Undoubtedly—to put it bluntly, turkeys do not vote for Christmas. That is an unfortunate way of putting it, but that is the reality. Since the programme for government was announced, much of the media narrative has been about how many civil servants will be cut and how many jobs will be lost. That has been very much the focus, rather than looking at it in a different way and asking how many communities will be empowered and how many new and different types of jobs will be created.

It is about looking only at the headline figures, rather than thinking about how we rewire and deliver better outcomes. The whole discussion is still very much about the inputs; it is as though the structures by themselves will magically fix the way in which the country operates, but there has been nothing about how changing those structures leads to better output. If you bring in those community groups, you can talk about the outputs and ask, "What does this mean to individuals in our community?"

12:15

I have not seen anything that talks about how having two health boards is going to help somebody get to their GP, get an appointment, go through the waiting list, get the help that they need or access social care. We need to focus on the outcomes. If you start from the design point of asking how we improve the outcomes and work back, you end up with a different conversation, rather than simply saying, “We need to find money—let’s just cut certain things.”

The Deputy Convener: At great risk of going back down the bonds rabbit hole, I have a question for Professor Gallagher.

You said that, in terms of administration costs, a bond scheme could cost the Scottish Government tens of millions of pounds. I am aware that Aberdeen City Council issued something like £370 million-worth of bonds. Has anybody done a review of how much that has cost the council in terms of the administration set-up? There is obviously some learning there. I am not comparing the council to the Scottish Government, but that means that issuing bonds has been done in Scotland before.

Professor Gallagher: I am not aware of the Aberdeen story, I am afraid—to be honest, I am slightly surprised to learn of it. Historically, local authorities in Scotland and elsewhere have issued bonds, but very few now do. There is a very limited local authority bond market. In all cases, bonds issued by local authorities had a spread, in the jargon, over bonds issued by the central Government.

The Deputy Convener: If my phone is correct—I was not scrolling through Twitter—it was city bonds that Aberdeen City Council issued.

Professor Gallagher: It may have been a structured product rather than a liquid bond.

The Deputy Convener: Okay. If colleagues have no other questions, I will put one more question from the chair. We heard from the previous panel about restrictions in the fiscal framework, in particular around borrowing, as it introduces some risks and less flexibility.

My question is for Professor Gallagher. As I understand it, the fiscal framework is due for review in a couple of years’ time. Is that mandatory, or is it almost within the gift of the UK Government? Obviously any changes would require a negotiation between the two Governments, but does the UK Government, in effect, control the fiscal framework as regards whether there will be a review and changes will be made? Could other events overtake that, and take priority over a review?

Professor Gallagher: My recollection is that when the first fiscal framework was created, which was after the devolution of taxes under the Scotland Act 2016, it contained a provision for a review after five years. I imagine—although I have not checked—that the present framework contains the same provision, because it would undoubtedly be in the interests of the UK Government, as well as the Scottish Government, to have a review.

The Deputy Convener: I have one final question, which is for Stephen Boyd. At the outset, you spoke about optimistic growth, which you said is not realised. Is that over the long term?

From year to year, the Scottish Government is working off estimates from the Office for Budget Responsibility and the Scottish Fiscal Commission. We saw in the latest reconciliation that the Scottish Fiscal Commission had overestimated income tax revenues by £200 million, so there was an overestimate, but that optimism was on a very small scale. Is that what you are getting at?

Stephen Boyd: All that I am trying to say is that when you look at the devolved settlement, the powers that the Scottish Government has are very relevant to longer-term growth. It has considerable supply-side powers, and if it does the right thing with those powers, you would expect growth to be higher in the longer term than it otherwise might be.

However, its ability to affect growth in the short to medium term is massively constrained. The way that you affect growth in that period is through policies that affect aggregate demand, and we do not really have those powers.

With regard to the debate about how we address the fiscal gap by the end of the decade, we have to be very cautious about whether devolved policies leading to higher growth in Scotland will make any kind of meaningful dent in that gap.

Professor Gallagher: In the previous session today, which was very informative, the panel discussed the technical issues around the management of uncertainty in the stream of revenues. The fiscal framework is the place to address that. I agree with Stephen Boyd that the supply-side tools that the Scottish Government has are long-term, not short-term, tools. We have probably gone beyond—at least, I hope we have—the world in which we use macroeconomic policies to create temporary booms, because they come back and bite you as they become temporary downturns.

However, there may be scope for further improvements to the fiscal framework in order to increase the certainty available to the Scottish Government, although perhaps at a price overall. As you rightly say, on one measure, the uncertainties are really quite small—they account for hundreds of millions of pounds, in a budget of many billions. However, at the margin in public spending, you are always arguing not about the £60 million, but about the couple of billion pounds at the edges, so they are quite significant year to year.

As I heard in the previous session, the Scottish Government has a set of tools to manage that. Those include building up reserves so that, in a bad year, you can fall on the reserves. The temptation, however, is to spend every penny that you have every year, and that is an error.

The Deputy Convener: But the reserves have a limit.

Professor Gallagher: I beg your pardon?

The Deputy Convener: The fiscal reserves that the Government is allowed have a limit.

Professor Gallagher: Of course—yes, unsurprisingly, but if you spend it all in the first year, you have hit the limit.

The Deputy Convener: Okay.

A big thank you to our three witnesses for sticking with us, as we started a wee bit late.

The next committee meeting is on Wednesday 16 September, at which we will continue hearing evidence on pre-budget scrutiny. That brings the public part of the meeting to a close—thank you, colleagues.

12:22

Meeting continued in private until 12:49.

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